S. HRG. 101-119

RISK RETENTION

HEARING

BEFORE THE

SUBCOMMITTEE ON THE CONSUMER

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

RISK RETENTION

MAY 3, 1989

Printed for the use of the
Committee on Commerce, Science, and Transportation

U.S. GOVERNMENT PRINTING OFFICE

99-266 O WASHINGTON : 1989

S261-47

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ERNEST F. HOLLINGS, South Carolina, *Chairman*

DANIEL K. INOUYE, Hawaii
WENDELL H. FORD, Kentucky
J. JAMES EXON, Nebraska
ALBERT GORE, JR., Tennessee
JOHN D. ROCKEFELLER IV, West Virginia
LLOYD BENTSEN, Texas
JOHN F. KERRY, Massachusetts
JOHN B. BREAUX, Louisiana
RICHARD H. BRYAN, Nevada
CHARLES S. ROBB, Virginia

JOHN C. DANFORTH, Missouri
BOB PACKWOOD, Oregon
LARRY PRESSLER, South Dakota
TED STEVENS, Alaska
ROBERT W. KASTEN, JR., Wisconsin
JOHN MCCAIN, Arizona
CONRAD BURNS, Montana
SLADE GORTON, Washington
TRENT LOTT, Mississippi

RALPH B. EVERETT, *Chief Counsel and Staff Director*
WALTER B. MCCORMICK, JR., *Minority Chief Counsel and Staff Director*

SUBCOMMITTEE ON THE CONSUMER

RICHARD H. BRYAN, Nevada, *Chairman*

ALBERT GORE, JR., Tennessee
WENDELL H. FORD, Kentucky
CHARLES S. ROBB, Virginia

SLADE GORTON, Washington
JOHN MCCAIN, Arizona
ROBERT W. KASTEN, JR., Wisconsin

CONTENTS

	Page
Opening statement by Senator Bryan	1
Opening statement by Senator Kasten	2
Opening statement by Senator Gorton	3
Opening statement by the Chairman	4

LIST OF WITNESSES

Bossman, David, president, Amiercan Feed Industry Insurance Co	94
Prepared statement	97
Questions of Senator Bryan and the answers	104
Gates, David, president, National Association of Insurance Commissioners	20
Prepared statement	23
Questions of Senator Bryan and the answers	40
Howard, Susanne, Associate Under Secretary for Economic Affairs, Department of Commerce; accompanied by Edward T. Barrett II; and Jane W. Molloy, Office of Economic Affairs	4
Questions of Senator Bryan and the answers	14
Questions of Senator Gorton and the answers	18
Koch, Karl W., president, Savers Property and Casualty Insurance Co	168
Prepared statement	171
Questions of Senator Bryan and the answers	182
Laborde, Lucien P. Jr., on behalf of the National Association of Insurance Brokers	136
Prepared statement	138
Questions of Senator Bryan and the answers	146
McIntyre, James T.; counsel, Risk and Insurance Management Society, Inc	109
Prepared statement	112
Questions of Senator Bryan and the answers	120
Mullen, Michael J., counsel, National Risk Retention Assn	45
Prepared statement	48
Questions of Senator Bryan and the answers	88
Questions of Senator Gorton and the answers	87
Salisbury, John, on behalf of the Public Risk Management Assn	185
Prepared statement	187
Questions of Senator Bryan and the answers	197
Shaffer, George, on behalf of the Independent Insurance Agents of America and the National Association of Casualty and Surety Agents	153
Prepared statement	156
Questions of Senator Bryan and the answers	164

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

Dolan, Douglas C., Jr., senior vice president, Schinnerer & Co., Inc., letter	20

RISK RETENTION

WEDNESDAY, MAY 3, 1989

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON THE CONSUMER,
Washington, DC.

The subcommittee met at 2:10 p.m. in room SR-253, Russell Senate Office Building, Hon. Richard H. Bryan [chairman of the subcommittee], presiding.

Staff members assigned to this hearing: Kevin Curtin; Linda Lance, staff counsels; and Chuck Harwood, minority staff counsel.

OPENING STATEMENT BY SENATOR BRYAN

Senator BRYAN. Good afternoon, ladies and gentlemen. I welcome all of you at this oversight hearing on the issue of risk retention.

As always, I am pleased to be joined by Senator Kasten and other members of the subcommittee who will be arriving later during the course of this hearing. I would also note the past efforts in this matter by the distinguished Chairman of the Commerce Committee, Senator Hollings, and other committee members.

Senator Kasten is going to have an opening statement that he will share with us in a few moments.

Product liability risk retention was first addressed by the Congress in 1981 with the enactment of a Federal law intended to assist with the problems of unaffordability and unavailability of insurance. It was hoped that this alternative to the traditional insurance marketplace would benefit manufacturers of products by creating new capacity in the market and by promoting greater competition among insurers.

Amendments to the risk retention legislation were enacted in 1986 because the Congress recognized that organizations such as day care centers, corporate officers and directors, nurse-midwives, and many small businesses had experienced great difficulty in obtaining liability insurance. I might also note that when I was Governor of Nevada I became familiar with some of these problems in securing liability insurance at affordable rates.

In 1986, the scope of the Act was expanded to purchasers of general liability insurance, although the basic structure of the Act was retained.

In September 1987, as required by the 1986 amendments, the Department of Commerce issued a report which found that the amended Act was generally fulfilling its objectives, but the Department identified certain areas that needed further consideration and possible amendment. A subsequent report is expected later this

year and that updated data will provide additional information for our use in evaluating the success of the 1986 amendments.

We will receive testimony today from persons and organizations interested in this matter. Representatives from the Department of Commerce, the National Association of Insurance Commissioners, who are charged with overseeing insurance transactions in each state, insurance agents, risk managers, insurance brokers, and others will appear, including some individuals who have personally experienced the formation of groups under the Act.

Before we begin with our testimony, as I have indicated, Senator Kasten has indicated he would like to make an opening statement. Senator Kasten.

OPENING STATEMENT BY SENATOR KASTEN

Senator KASTEN. Mr. Chairman, thank you.

First of all, Mr. Chairman, I would like to thank you for conducting this hearing.

Two and a half years have passed since the Liability Risk Retention Act was enacted. A year and a half has elapsed since the Commerce Department's first implementation report was submitted to the Congress in September of 1987. In that report the Commerce Department states:

> The Act is not working as well as intended and some modification of the Act is necessary if it is to serve its purposes more effectively.

Since that time, Mr. Chairman, there have been a number of reviews by the American Bar Association's Committee to Improve the Liability Insurance System and a number of other groups.

In general, it seems pretty clear that the time has come for this subcommittee and the Congress to revisit the Risk Retention Act, and I therefore applaud your leadership in this regard.

I am proud to have been the sponsor of the legislation in the Senate that established the Risk Retention Act in 1981 and the legislation that clarified its scope in 1983. I also sponsored the amendment which broadened its reach, which you referred to in your statement, in 1986. And a number of the members of this committee have worked hard and demonstrated great leadership on this issue.

I believe strongly that the Risk Retention Act can play an enormously beneficial role in enhancing the availability of liability insurance coverage at reasonable rates to commercial purchasers of liability insurance, particularly in smaller businesses, who are always hit hardest by downturns in the insurance cycle.

Mr. Chairman, when you mentioned the day care centers you point out that it is the smaller business, the newer business, the emerging businesses that are hit hardest by the difficult liability problems.

In that regard, I think it is important to point out that the delegates in the 1986 White House Conference on Small Business gave the risk retention amendments of 1986 an important boost. I would say it was a critical boost, when they in their conference voted to include expansion of the scope of the Risk Retention Act in their recommendations. It was in large part because of that that we were able to move forward with the legislative process.

For the Risk Retention Act to work, Congress' policy decision to preempt state laws which hinder the formation and multistate operation of risk retention and purchasing groups and to focus the primary responsibility for regulating these groups to a single state must be respected.

So we ask ourselves, what has happened? On the one hand, we have witnessed a broad interest in programs authorized by the Act. I understand that some 50 risk retention groups and 100 or more purchasing groups are in operation today and that many more are in some stage of formation.

On the other hand, I am deeply concerned that state regulatory developments and in two instances decisions of courts, Federal courts, are inconsistent with the letter and the spirit of the Act as we drew it up in 1981 and improved on it in the subsequent legislation which I referred to. If we fail to respond, we in this committee and the Congress, this growing industry will not be able to achieve results anywhere near its full potential.

Today's witnesses should be particularly informative, and first I hope that the witnesses will shed some light on where the Congress may have come up short in clearly defining the statute in its final form.

To the extent that greater clarity and guidance is needed, I hope that this subcommittee and the Congress will act with dispatch to provide it.

Secondly, I am interested in hearing the views of all of our witnesses regarding any substantive changes that could be made in the Act to improve its utility to current and prospective users and to protect the public, provided the suggestions of changes are consistent with the underlying policy on which the current law is based.

Mr. Chairman, I thank you for focusing the attention of our subcommittee on the Liability Risk Retention Act and I look forward to working with you.

Senator BRYAN. Thank you very much, Senator Kasten. We appreciate your involvement historically and on the occasion of this subcommittee hearing as well.

OPENING STATEMENT BY SENATOR GORTON

Senator GORTON. Mr. Chairman, I have a brief opening statement for the record.

Senator BRYAN. It will be included.

Senator GORTON. Mr. Chairman, thank you for holding this hearing today on the Risk Retention Act. Oversight of this act and the 1986 amendments is certainly a timely issue for the Consumer Subcommittee.

I worked with Senator Ford and some of those testifying today in 1986 to develop a substitute amendment for the Risk Retention Amendments, as then introduced. As I said then, the purpose of the Act is a good one—to ensure greater availability of insurance at reasonable rates.

I was concerned, however, that states have sufficient regulatory control over risk retention groups and purchasing groups. The states have an essential role in regulating these activities.

These two goals necessitate a careful balancing to ensure adequate regulation without unduly inhibiting formation and operation of risk retention groups and purchasing groups. During the hearing today, I will be most interested to learn whether that balance has been achieved.

Again, Mr. Chairman, thank you for holding today's hearing. I look forward to hearing from today's distinguished witnesses.

Senator BRYAN. Thank you Senator Gorton.

I have a statement that the Chairman would like to have included in the hearing record.

[The statement follows:]

OPENING STATEMENT BY THE CHAIRMAN

Mr. Chairman, I am pleased that the Consumer Subcommittee has scheduled this hearing on oversight of the Risk Retention Act, in particular the amendments we adopted in 1986.

I was an original cosponsor of the legislation that was enacted in 1986 because I felt then, as I do now, that this Act makes it easier for businesses, professional groups, local governmental entities and others to purchase commercial liability coverage.

We often hear about the insurance "crisis", when organizations and individuals are unable to obtain the coverage they need, or cannot afford the insurance protection that they must have to operate. The cycles in the insurance industry are well recognized, with periods of easy availability followed by unavailability and high prices. Alternatives such as those provided under this Act are much needed, to ensure that entities are not forced to operate without insurance.

I was particularly pleased to note that the 1987 Department of Commerce report found that the 1986 amendments generally were achieving their purposes. I look forward to the testimony of the witnesses today, in an effort to understand more clearly whether the 1986 amendments need further refinement.

Senator BRYAN. We will begin our testimony with Ms. Susanne Howard, the Associate Under Secretary for Economic Affairs. Ms. Howard is joined at the witness table this afternoon by Mr. Ted Barrett and Ms. Jane Molloy from the Office of Economic Affairs.

Ms. Howard, we have a formal statement that we will incorporate as part of our record. I would ask you, if you would, to confine your comments to five minutes so that the subcommittee members might be able to ask questions of you, Mr. Barrett or Ms. Molloy.

The floor is tendered to you.

STATEMENT OF SUSANNE HOWARD, ASSOCIATE UNDER SECRETARY FOR ECONOMIC AFFAIRS, DEPARTMENT OF COMMERCE, ACCOMPANIED BY EDWARD T. BARRETT II; AND JANE W. MOLLOY, OFFICE OF ECONOMIC AFFAIRS

Ms. HOWARD. Thank you and good afternoon, Mr. Chairman and members of the committee.

It is a pleasure for me to be here today to discuss the Liability Risk Retention Act of 1986 and, as you indicated, Jane Molloy and Ted Barrett are both joining me at the table and would be happy to answer questions at the conclusion of my testimony.

The Act provides a marketplace solution to disruptions in the affordability or availability of liability insurance. It is important that the Act work as intended by the Congress and I think the problems that have been identified can be resolved.

Today's discussions are timely in that they are occurring during a period of relative calm in the liability insurance market.

The original Risk Retention Act was drafted by the Department of Commerce in the late 1970's and we have had a continuing interest in the Act and its operation in the intervening years.

The original Act addressed only product liability insurance, the critical problem of that time. Many companies, mostly small and medium sized firms, could not obtain or could not afford product liability insurance coverage.

Insurers regarded product liability as a highly volatile risk and were reluctant to commit their limited insurance capacity to it. The individual premiums of the smaller companies were not attractive compared to the perceived risk.

The Act as passed in 1981 permitted these companies to form their own insurance companies—risk retention groups—or to purchase insurance in the commercial market as a group—a purchasing group.

The risk retention groups would create new capacity and the purchasing groups would present an attractive premium base with lower administrative costs for a commercial insurer. In either case, the groups could serve members in all states with minimal regulatory barriers.

The Act was signed in 1981 and the insurance market eased at the same time. With product liability insurance more readily available, only a handful of risk retention groups and purchasing groups were formed.

It has been observed that insurance, at least the property-casualty segment of the market, follows a cyclical pattern. A "soft"—low price market, high availability—market is followed by a "hard" market where buyers scramble for affordable insurance.

The available insurance capacity is often consumed by the most predictable risks and the largest buyers. The rest "go bare"—uninsured—or seek alternative insurance markets. Some insurance experts have noted that the cycles have become sharper and closer together, leading to a relatively unstable market.

They note also that some of the more difficult risks, such as environmental impairment and day care centers, continue to have difficulty in obtaining coverage even in a soft market.

A new hard market created difficult insurance conditions across a broad segment of the economy by 1985. Those affected included medical providers, day care centers, municipalities, waste disposal companies, directors and officers, and many others.

The Congress responded quickly with amendments to the 1981 Act that permitted virtually all liability insurance to be written under the Act. The basic structure of the 1981 Act was followed in the amendments, but a number of new safeguards were included to ensure that buyers of insurance and claimants would be protected. As I understand it, these safeguards were included after extensive consultation with state insurance regulators and other interested parties.

The insurance market softened not long after enactment of the amendments in 1986. But, unlike the 1981 experience, about 350 purchasing groups and 60 risk retention groups have been formed.

The lines of liability insurance written for these groups closely parallel the problem areas brought to the Congress' attention in 1986. For example, health care providers, environmental services,

and professionals such as architects, engineers, and directors and officers have each formed several groups.

The Congress directed the Secretary of Commerce to provide two reports on the implementation and operation of the Act, in September of 1987 and September 1989. This requirement has provided us the opportunity to follow developments and maintain contact with state insurance commissioners and participants in the groups formed.

The 1987 report concluded that the Act was serving its intended purpose. Since the Act had been in effect for less than a year, it was too early to fully assess such areas as possible unsound financial and commercial practices that might be affecting the operation.

Also, we were unable to address financial difficulties the groups might have encountered because of lack of annual reporting. We did, however, have several recommendations for modifications of the Act that we believe are necessary to permit it to serve its purposes more effectively.

A copy of the report's proposals is attached. Basically, the proposals fall into two categories:

First, duplicative regulatory burdens on those seeking coverage under the Act should be reduced to allow them to reap the full benefit of cost reductions and the intended ability to operate with minimal regulatory hurdles in all states.

The second category of proposals would provide that regulators in the several states have the information and other tools to assure that risk retention groups and purchasing group insurers are operating properly in their jurisdictions and that they have the solvency to carry the risks they accept.

In general, we found that the risk retention group section of the Act was working reasonably well. The purchasing group section, however, had encountered difficulties in several states, and I will limit my discussion to that area.

The Act provides different structures of regulation and preemption for risk retention groups and for purchasing groups. We found that the structure established for risk retention groups is generally accepted by the states. However, the structure of regulation and preemption for purchasing groups needs to be clarified.

The Act needs to be more explicit regarding whether purchasing groups and purchasing group insurers are subject to multistate or single state regulation. States differ in their interpretation of the Act on this issue.

Some states have said that every state in which a purchasing group has members has regulatory authority, while others believe that such authority lies with the state in which the purchasing group is domiciled or has its principal place of business.

The Commerce report recommended limiting regulation—including rate and form regulation—of purchasing groups and purchasing group insurers to a single state. While other states should have authority to challenge a purchasing group or its insurer if it is operating in an unsound financial manner or is engaging in fraud or commercial abuse, the purpose of the Act is best served by treating purchasing groups and their insurers similar to risk retention groups in the manner in which they are regulated.

At the same time, it is clear that state regulators need sufficient information to be able to determine how a purchasing group, and particularly a purchasing group insurer, is performing. We believe that the states currently lack sufficient information about purchasing group insurers and that some insurers are virtually unreachable by domestic regulators.

The Commerce report recommended requiring purchasing group insurers to file the same information required of risk retention groups—including designation of agent for service of process—in every state in which they are writing purchasing group insurance. This requirement would provide the tools regulators need to oversee purchasing groups and their insurers.

We believe that the enactment of these recommendations would make the Act more workable for purchasing groups and their insurers, while at the same time providing sufficient information to regulators to ensure that the consumers are adequately protected.

Work is under way for the second report, which you will receive in September. We have published in the Federal Register a request for comments and information from all interested parties.

We have maintained close contact with regulators and the users of the Act and do not anticipate that the conclusions of the second report will differ significantly from those of the first. As a matter of fact, time and events have strengthened the justification for the original conclusions.

We expect that some financial data may be available to provide a better picture of the scope of the Act and its position in the casualty insurance marketplace.

I appreciate the opportunity to testify before the committee today and I particularly appreciate your interest in addressing the Liability Risk Retention Act now so that the problems with it can be worked out in advance of another hard market.

We will be happy to answer questions.

Senator BRYAN. Thank you very much for your testimony, Ms. Howard.

I am going to ask the questions generally of the panel, so I invite Mr. Barrett and Ms. Molloy to respond to any of these questions that I have.

In general, the Act is crafted in such a manner that there is a balancing between the preeminence of state regulatory control and an overriding Federal interest, which you have outlined in terms of the availability and the affordability of insurance.

There has been criticism directed to the Act and specifically to states, insofar as the rate structure itself, it being contended that in some states the fees paid are very reasonable and appropriate for the administrative burden required. In other states, it has been argued that the cost has been so high as to in effect be not primarily motivated by an administrative cost recoupment, but to erect an artificial barrier.

I am wondering if you might comment on that criticism as to whether you find it valid or invalid. Again, I tender that question to any member of the panel.

Mr. BARRETT. We have heard that some states are charging as much as $1,000 for registration of a risk retention group. It is hard to really know what the basis of that fee is.

We recognize this is an area that we have got to look at in our next report. So far we do not have a full list of the fees that are being charged in the various states.

Senator BRYAN. Mr. Barrett, it would be helpful for us to have that. You say that you have not been able to validate that, and I offered the question not by way of reaching any conclusion, at least as far as this member is concerned, but that criticism has been voiced.

It would be helpful for us to have at least the data to know whether that is in fact valid and if indeed the registration fees, as you have indicated you have heard—apparently you have not been able to verify that—are $1,000.

Mr. BARRETT. We will have a full list in our next report.

Senator BRYAN. I think the states have a legitimate interest and concern in the solvency of these operations. Many of us who come from a state perspective have experienced firsthand, not with respect to risk retention or purchasing groups, but with respect to insurance carriers generally, the problem of solvency.

So it does strike me to be a very legitimate and bona fide concern on the part of the states about their ability to ascertain the financial solvency of a proposed risk retention or purchasing group.

Some have suggested that we ought to circumvent or preempt the states entirely on that. Share with us, if you will, what is your perspective and how we should address that. What changes, if any, should be made? And again, the question is to the panel.

Ms. Molloy, you look like you are eager to respond. Please.

Ms. MOLLOY. We are equally concerned about the solvency issue. As we note in the report, there are legitimate concerns about the handling of purchasing group insurers. Currently, the Act addresses purchasing groups, but does not specifically deal with the insurers of purchasing groups. We feel that regulation of purchasing group insurers should be limited to one state, but that they should have to file the same information that risk retention groups file in each state in which they do business.

Senator BRYAN. Should be limited to one state? I do not mean to interrupt you.

Ms. MOLLOY. One state of regulation, but they should have to file the same information with every state in which they have members. That is, they should be treated the same as risk retention groups, so that all insurance commissioners in the states in which they have members have the opportunity to look over their financial reports and make their own determination as regards solvency.

We feel that there is ample authority under their own state laws and in the Act for them to then challenge the solvency of risks retention groups or purchasing group insurers.

Senator BRYAN. Ms. Molloy, let me propound this hypothetical. If I understood you correctly, and please advise me to the contrary if I misunderstood what you have said, you are indicating that the regulation should be under the aegis or jurisdiction of one state and all other states would have to comply, in effect, with that regulation where perhaps the individuals who might be included within the group might happen to be living or conducting business; is that correct?

Ms. MOLLOY. We believe that one state should be primarily responsible for the regulation of purchasing group insurers. However, all other states would have the authority to challenge the purchasing group insurers if they felt it was in a financially hazardous condition, the same as they currently have the obligation to do with regard to risk retention groups.

Senator BRYAN. I see. So hypothetically, if the principal place of business or the domicile was in state X and, for whatever reason, that state had made a public policy determination to encourage the domestication of the operation in that state and had very, very loose financial requirements—let us assume for purposes of this hypothetical that reasonable people would have to conclude that maybe they were a little bit shaky—you are not suggesting then that other states in which the business or the company might operate would be bound by those loose financial requirements of the state?

Ms. MOLLOY. No. Any state, if it felt that solvency was being questioned, could ask for an examination of that company.

Senator BRYAN. And would have the right to, in effect, to revoke or to disallow the conduct of business within that state?

Ms. MOLLOY. Using the appropriate authority under their laws.

Senator BRYAN. Using the appropriate authority. I do not mean to be contentious here, but we are using some qualifying language. You are talking about under the law of that particular state or under the law of the state in which the risk retention group was domiciled?

Ms. MOLLOY. They could ask—under the law, they would ask the primary state to conduct an examination. And if the state chose not to, they could go to a court of competent jurisdiction and request an injunction.

Senator BRYAN. Would that not be extraordinarily cumbersome? Let us again assume that, for whatever reason, the state in which the group was domiciled or in which it had its principal business took a rather cavalier attitude. Do you mean that a state in which people are conducting business in effect would have to implore, entreat, please take a look at this?

And if they chose not to do so, the only recourse would be for that state to go to court? I mean, clarify this if I have misconstrued—and my time is limited and I see the ranking member has joined us, so I do not want to encroach upon anybody's time.

But Mr. Barrett, if you would. I may have done violence to what you intended, but that did kind of get me a little exercised.

Mr. BARRETT. Well, I think the Act is very specific in a couple of places. Number one, the Act is quite clear on the information that has to be supplied by a risk retention group. That information is very much the same as the information that would be supplied by any admitted insurer. So that a regulator in any state in which the risk retention group is operating would have the same information as it would have about any domestic company or licensed company within their state.

Upon getting that information and believing that a risk retention group and, if our recommendation were followed, any insurer of a purchasing group, the same information would be available, a commissioner would have the ability just to ask the state of domi-

cile of the insurer to conduct an audit. And if they do not or do not want to, then it would have the opportunity to go ahead and do it itself.

But they would have up front all of the information, the financial information about the group that is operating within their state.

Senator BRYAN. Mr. Barrett, thank you very much.

Senator Kasten, do you have some questions?

Senator KASTEN. Thank you.

Ms. Howard, your testimony shows that, some review of the Risk Retention Act indicates some concern about possibly inadequately capitalized insurers of purchasing groups. But then you went on to say that the Department of Commerce would impose certain minimum financial requirements, or would propose certain minimum financial requirements that would be imposed on insurers of a purchasing group.

Would these minimal requirements that the Department of Commerce proposes deal with some of the questions that the chairman was just talking about, in terms the establishment of basic parameters? Will the Department establish those parameters, which in effect could become guidelines, to establish the consistency that we are trying for?

Is that correct? And do you believe that the regulations which you are now proposing would adequately do that?

Ms. HOWARD. Yes, I do. Yes, I do, and I think there was a little misunderstanding.

Senator KASTEN. You might get that microphone closer.

Ms. HOWARD. What we were offering is that the purchasing groups be treated the same as the risk retention groups and with single state regulation. That did not mean that we were going to exclude them from reporting or exclude them from financial responsibility, and I think that was the unclear part of the statement.

Mr. BARRETT. Senator, just one thing. We are not proposing that we would do something by regulation.

Senator KASTEN. I understand that.

Mr. BARRETT. We would suggest that the Act be amended, and you would do that, and these standards would be written into the Act as something that any insurer of a purchasing group would have to follow. And we think it would help very much in the areas the chairman has brought up.

Senator KASTEN. Well, frankly, between now and the time that we pass legislation, I want to do everything I can to conform this Act with the letter and the spirit in which it was passed. Some of these distinctions which we are now fighting about are distinctions which have been established by people opposed to even the spirit of what we hoped to do.

Those individuals actually opposed the bill initially, and they reluctantly accepted it. Now they appear to be opposing the bill abain by working the edges.

What we must do is to figure out how much we can do, you at Commerce and us on this committee, assuming that the committee is still sympathetic to the general concept, how much we can do even in the next several months in terms of establishing what we

meant to do with the original legislation at the same time, we must recognize the fact that there are still some people that are generally opposed to it.

Ms. Howard, can we address the questions on page 6 of your testimony, where you said we have to be more explicit regarding whether purchasing groups and purchasing group insurers are subject to multistate or single state regulation?

You also mention that every state in which a purchasing group has members has regulatory authority, while others believe that such authority lies within the state in which the purchasing group is domiciled or has its principal place of business.

Now, I can tell you in a hearing, in a letter, maybe even I can go back to the debate that occurred on the floor or the debate that occurred in the committee, what we meant when we passed this legislation. Will that help you and would that give you the ability to enforce these laws in the way that we meant them to be enforced?

We intended it to be in the place it is domiciled or its principal place of business. We were clear on some of these multistate-single state ideas. And we sure as heck were clear about all these conflicting forms.

The idea here is to have uniformity, consistency and relative ease of entry into this area. That is what the Congress meant when we passed this law.

Now, are there ways, other than passing legislation—and I should say in addition to that process, because we can work the legislative process also. Are there ways, for example a letter from me as the sponsor of the bill, saying this is what we meant?

Are there any other ways that we can indicate to what we intended, because many want to establish these rules in the spirit in which we intended?

Ms. HOWARD. Okay. I will have Mr. Barrett help me on this question, but it is my understanding that we do not enforce the Act, and implementation of our recommendations require amending the 1986 Act.

So "no" to your question; we really do not have enforcement powers. But we did bring forth the kinds of solutions we thought would clarify some of those ideas that were presented in the original Act of 1981 and 1986.

Mr. BARRETT. Senator, your comments will be very helpful to us in our report which we will be publishing.

Senator KASTEN. We have been through a bunch of these reports.

Mr. BARRETT. That is right.

Senator KASTEN. And frankly, it is not having the effect of getting back to the spirit, which is really what I am concerned about here. I am not concerned about dotting "i's" and crossing "t's".

We knew what we meant and it is a little different from that now.

Mr. BARRETT. I agree.

Senator KASTEN. And when you come back with your reports, my hope is that some of these things can be worked out even before we pass yet another Risk Retention Act amendment bill. And I guess we are probably going to be in the business of doing that, and we will be working with you.

I see that my time has not quite expired. Let me ask one final question. It is a more detailed question. Based on your review of the implementation of the Act, do you believe or is it your position that the State of Pennsylvania versus Corcoran decision, which requires an admitted insurance company providing coverage to a purchasing group to file its rates and forms in each state, has discouraged some insurance companies from providing coverage to purchasing groups?

Has that become an impediment?

Mr. BARRETT. I have no personal knowledge that it has. I know that it does create a problem, particularly for a smaller insurance company that would have to go through that exercise in many states.

Senator KASTEN. And then do you think——

Mr. BARRETT. For the larger companies, I think it probably is not a great burden.

Senator KASTEN. Do you think that requiring approval of rates and forms in each state is necessary? I think we touched on this before. I do not think it is. But do you think it is necessary to properly regulate insurance provided to a purchasing group?

In other words, can a review of rates for purchasing groups by one state provide adequate regulation regarding insolvency?

Mr. BARRETT. I think it is proper and I think it is our belief that it was the intent originally that an insurer of a purchasing group would file in the state of domicile or the state of the principal place of business, and that that rate as filed would be the rate that would be used throughout the country.

As far as the solvency issue is concerned, we have made some suggestions, since we did the report, which would treat, the insurer the same as a risk retention group. And I think this would go a long way to easing the problem that many regulators have about whether or not these companies operating within their jurisdictions are really sound.

There should be the one state that does have the look, and then every other state would have the same information.

Senator KASTEN. Which is where we were with Ms. Molloy before.

My time has expired and I think all of us are anxious to move forward to the other witnesses.

But I do hope we can work at least on some of these problems before we pass legislation, and it is clear that some kind of legislation may be needed.

Senator GORTON. I will submit any questions I have in writing.

Senator BRYAN. That will be done, Senator Gorton.

Before the witnesses are excused, as a follow-up to Senator Kasten's questions, I think it would be helpful for the committee if you have specific recommendations. I think that is what Senator Kasten is asking for.

You have outlined some problem areas, but it is a bit nebulous. Specifically what are you recommending? What are you urging us to do?

I think clearly the time is up for this panel and we want to move on to other witnesses. But we would appreciate receiving that, in

addition to the response to my questions, Senator Gorton's questions and any specific questions that Senator Kasten has.

We thank you very much for your testimony this afternoon.

[The following information was subsequently received for the record:]

ANSWERS TO QUESTIONS FROM SENATOR BRYAN

Q: Your report in 1987 found that the Risk Retention Act generally was meeting its objectives, and identified some areas that bear further consideration. Since the report was issued, are there additional specific findings that you feel should be brought to the Subcommittee's attention?

A: Because the 1987 report was written so soon after the passage of the 1986 amendments, there was no information on possible unsound financial and commercial practices or financial difficulties of groups. Nevertheless, the report expressed concern that the Act as written provides insufficient information and safeguards for regulators to adequately guard against improper and harmful financial practices of groups. The report therefore recommended that the Act should require more information particularly from purchasing group insurers and that certain other regulatory conditions be imposed such as limiting the use of alien insurers. The Subcommittee should be aware that since the publication of the 1987 report there have been financial abuses by some companies acting pursuant to the Act. While the abuses point to the desireability of amending the Act as suggested in the report, it is also apparent that the states, under their existing authority, have been able to challenge companies whose practices they have found questionable.

Another area in which there have been problems is that of financial responsibility requirements. We are currently studying this issue and will address it in the next report.

Q. Some complain that the states use their regulatory authority to thwart the purposes of the Act, namely to provide relatively easy alternatives, while also ensuring that consumers are protected. Have you found that criticism to be valid: If so, what regulatory burdens have been created?

A: The criticism you refer to most likely relates to the differences among the states in their interpretation of the "location" clause and the issue of whether the Act calls for single-state or multi-state regulation under the purchasing group section of the Act. Those who believe the Act calls to single-state regulation see requirements such as rate and form approval in multiple states as undue regulatory burdens which thwart the purpose of the Act. It is clear that some of the use of regulatory authority stems from legitimate concerns of regulators lacking sufficient information about purchasing group insurers operating in their states.

Q. The question of the "location" of a purchasing group seems to be the single most difficult issue regarding purchasing groups, since it determines whether that group's insurer must comply with the insurance laws of one or many states. Please provide information on some of the differing interpretations of that term, and why you think an amendment defining "location" as the principal place of business or state of domicile is better than other alternatives (e.g., where most members reside)?

A: Attached is a copy of Pages 70 - 79 of the 1987 report which detail and discuss the differing interpretations of "location". The issue has been litigated and the case of Frontier v Hager -- decided in favor of multistate regulation in the lower court -- is currently on appeal in the Seventh Circuit U. S. Court of Appeals. Defining "location" as the principal place of business or state of domicile is preferable to defining it as where most members reside because the former permit more stable regulation. Requiring a group to be subject to regulation where most of its members reside could force it to periodically change its regulatory state as a result of shifts in its membership list. Such a result does not seem desireable. The usual objection to the former definitions is that they permit "forum shopping; i.e., they permit a purchasing group to choose the state in which they will be regulated. We do not see this as a problem if the Act is amended to require more information about and requirements for purchasing group insurers so that all states are able to monitor their activity and intervene if there are solvency concerns. It doesn't matter whether "location" is defined as the legal domicile or a declared principal place of business. It is sufficient that one state is identified and there is communication with the state regulators.

Q. Having multiple state regulation of such matters as rates and forms is said to place burdens on those trying to establish purchasing groups. Nevertheless, your testimony acknowledges that state regulators today lack sufficient information about purchasing group insurers to guarantee their financial soundness. Is it enough to require that the state of domicile or principal place of business have regulatory authority? How would other states where the group had members ensure the sufficiency of the insurers assets and behavior?

A: The Act preserves state powers not specifically exempted by the Act and provides for the regulator to go to court to stop abusive actions. We would improve the current system by making more information available to state regulators and urge more cooperation and interaction among the several states in order to halt abuses.

Duplicative regulation such as a requirement to file rates and forms in every state can be unduly burdensome and unnecessary. A state regulator receiving information copies of rates and forms filings, knowing of special circumstances in his state, can notify the group and the approving regulator of these facts, and any action that may be appropriate may be undertaken. Full disclosure of financial data, rate and form filings and other required filings will provide each regulator with essentially the same information as that reported by admitted companies but this information is not a guarantee of financial soundness.

Q: I believe that the Department's 1987 report says that "the requirement to use a licensed agent in every state in which it is doing business seems to be the type of unnecessary burden which the Act sought to preempt." Why doesn't the Department feel that the use of licensed agents should be mandatory in all circumstances? If agents are not involved, who would be obtaining the insurance? If you feel that mandatory licensing should not be required, how do you respond to the criticism that not having a licensed agent involved in the transaction may leave a state without any way to protect consumers?

A: The 1987 report reviewed the Act and its legislative history and concluded that Congress intended to make the use of licensed agents permissive rather than mandatory. Several comments received had objected to state requirements regarding the use of agents and felt that their use was unnecessary. The report concluded that the use of a licensed agent was not always necessary and that some exemptions would be appropriate. Although we believe that some groups do not need representation by licensed agents because of the nature of the groups and their membership, we are reviewing this issue anew for the next report. The state has authority to intervene with a risk retention group, a purchasing group or a purchasing group insurer whether or not an agent is on the scene.

Q. Should the Act be amended to preempt the states from prohibiting municipalities and other government entities from forming groups under the Act? Why or why not?

A: The 1987 report interpreted the Act and its legislative history as including public entities among those with insurance availability problems, but stopping short of preempting state authority to prohibit such entities from using the Act. The

Congress seemed clear in its intent that states have control over their own political entities. Our recommendation dealt with an unintended impediment of state laws and we see no compelling reason to go beyond that posture.

Q: How many of the problem areas you have identified require a statutory fix? Could some or all of them be remedied by agreement among the state insurance commissioners?

A: Amendment of the Act seems necessary to achieve the twin objectives of making the Act more workable for groups and of protecting consumers. While many of the problems could conceivably be remedied through the joint action of the state insurance commissioners, so far this has not happened and it is probably unrealistic to assume that it will in the near future.

Q: What are the future prospects for risk retention and purchasing groups -- that is, do you think the Act will be increasingly used, or are the burdens prohibitive and too costly.

A: The Act was passed primarily to provide an alternative to the traditional insurance market during periods when insurance in that market is unavailable and unaffordable. Since the Act was amended, insurance availability has not been a problem for most buyers -- the market has been soft. When the market turns -- as it always has -- the Act is likely to be used more heavily to provide coverage.

Q: Some suggest that states impose filing fees as an indirect way of discouraging the formation of risk retention and purchasing groups. For example, I understand that in my home state of Nevada the filing fee is very low, while in other states it is $100 or even higher. Do you agree with this criticism? Are these fees being imposed to discourage formation of groups, and do they in fact act as a significant deterrent to establishing groups?

A: In preparation for the next report, we are currently examining the fees charged by the various states and the rationale for the charges. At this time our study is incomplete.

QUESTIONS OF SENATOR GORTON AND THE ANSWERS THERETO

1. In your testimony, you note that the part of the Risk Retention Act that concerns regulation of risk retention groups has worked reasonably well, but the part that concerns purchasing groups has worked less well. Should regulation of purchasing groups be revised to make it more closely conform to regulation of risk retention groups?

A. There is no need to change the regulatory structure as it relates to the purchasing groups themselves but there is a need for the Act to provide a regulatory structure for purchasing group insurers.

The Risk Retention Act does not specifically address the activities of purchasing group insurers. We believe that the purpose of the Act would be furthered and consumers better protected if the Act were amended to regulate the activities of purchasing group insurers in a manner similar to that of risk retention groups.

Under the Act currently, purchasing groups are required to provide each state only with the name of its insurer and the insurer's domicile. This dearth of information on purchasing group insurers coupled with the difficulties regulators could have in ascertaining the solvency of these insurers has undoubtedly contributed to the apparent discomfort of some states with the operation of purchasing groups.

Regulating purchasing group insurers in the same manner as risk retention groups and requiring purchasing group insurers to furnish the same type of information that risk retention groups have to furnish to each state should go far toward providing regulators with the information they need to assess the financial viability of purchasing group insurers doing business within their states. Risk retention groups file essentially the same information as do admitted companies. It is likely that the states will be more comfortable with the operation of purchasing groups if they have both sufficient information and a regulatory hook by which they can challenge financially troubled purchasing group insurers.

2. Based on the preliminary findings of your 1989 Risk Retention Act implementation report, is there reason to be concerned about the solvency of risk retention groups and purchasing groups?

A. Our preliminary findings cause us no concern about the solvency of any risk retention groups at this time.

We are aware of some problems with a few purchasing group insurers. Each of the problem situations of which we are aware has been or is being addressed by the state regulatory system. While it is unfortunate that these situations have arisen, it should be noted that regulators were aware of each of them early on. Using existing regulatory authority, states have issued cease and desist orders against purchasing group insurers where they have deemed such actions necessary. While we might not always agree with the appropriateness of the action -- at least in those instances where disagreement over multi-state or single-state regulation was the basis for the cease and desist order -- we would note that these actions show the ability of the states to regulate these groups.

As noted in our first answer, we believe that there is a need to provide a regulatory mechanism in the Act for purchasing group insurers. We further believe that it would be appropriate to establish minimum standards for purchasing group insurers. While these standards should not be set so as to preclude small or specialty insurers from operating under the Act, they should assure responsible financial and underwriting practices. It was certainly not the purpose of the Act to encourage "fly-by-night" or other unsound insurers. At the same time, the Act was created to ameliorate shortages in specialty lines of insurance. To some extent this market must use nontraditional carriers many of which are not rated by the major rating organizations. This should not be a concern so long as there is some assurance that they are financially sound.

3. Much controversy has apparently arisen concerning the word "located" in the section of the Risk Retention Act that specifies which insurance companies purchasing groups may purchase from. Where states have defined located to mean an insurance company admitted in each state in which the group is operating, what has been the impact on formation and operation of purchasing groups? Are purchasing groups avoiding those states?

A. Purchasing groups are operating in all states. A multi-state definition is not a constraint to insurers admitted or authorized in all states and some purchasing groups are able to use these 'national' insurers. Purchasing groups using insurers not admitted in all states have had more difficulty operating. Many purchasing groups are finding it difficult to operate because of the uncertainty of the rules and what they perceive as a hostile environment in some states. This is reputed to have had a chilling effect on the formation of groups but we are unable to quantify this in any manner.

Our primary concern is the effect that this environment would have on the utility of the Act in a hard market when capacity in the conventional market is sharply reduced and insurers stop writing certain types of risks. The Risk Retention Act was enacted to facilitate the use of alternative markets. In a hard market situation, small specialty insurers admitted in only one or a few states might be able to insure hard-to-place risks through purchasing groups if they could do so under a regulatory mechanism such as that available for risk retention groups. Closing the market to these insurers could render the Act impotent for its intended purpose.

Senator BRYAN. Our next witness is Mr. David Gates. Mr. David Gates is the President of the National Association of Insurance Commissioners and also happens to be the Insurance Commissioner of the State of Nevada.

Mr. Gates, welcome. It is my recollection the last occasion of your visit to the nation's capital you came down with food poisoning. I hope you are feeling better today. I do not think that there was any correlation between your presence here and the food poisoning. At least I choose not to believe that.

Mr. GATES. I hope so, too.

Senator BRYAN. As I have asked the other witness, if I could get you to confine your testimony to five minutes. We have your printed statement, which will be made a part of the record, and then of course please respond to questions of the subcommittee.

Mr. GATES. First off, I would like to thank you for the opportunity to be here today, in two fashions: one, to be invited to testify today; and another, to consider the appointment to be the Commissioner that you granted me in 1984.

I am really happy to be here so that we can discuss in what I consider a little bit more of a practical term the protections that we are talking about for the various people who are purchasing insurance, either through risk retention groups or other mechanisms around the country.

I am coming here today to speak about average citizens who we in the states and the state insurance departments (in our consumer services sections) deal with on a routine basis when they have their questions about what types of coverages to purchase, that they do not understand their coverage, or that they are not sure who is providing them coverage because of some confusion in the way that it has been presented to them.

This is the type of input that we would like to provide to you and have that made part of your deliberations when you consider this legislation.

To digress a moment and go back to some of the history of the legislation: in 1981 there was a problem with obtaining product liability insurance and a mechanism was sought that would be an alternative to the established insurance environment, which was felt at that time to have failed the purchasers of this type of insurance.

As this type of a situation occurred again in 1986, the same approach was used, the removal of certain state regulations because it was felt that those were burdensome and that we could solve this problem by making it easier for people to form insurance companies and easier for people to get those insurance products into the marketplace. So when we have a hard market, we remove controls.

That is the environment we are in now. We are once again here, although we do not have a proposal before you, as I understand it I recognize that the Department of Commerce has made certain recommendations in their report and I also recognize that there is a bill draft that has been circulated by the Department of Commerce. But I assume that that is not the subject of this hearing and will not address those directly.

But what we are talking about here is the nature of the protections and the nature of the states in the area of Risk Retention Act. The states in general have accepted (although we opposed, there is no question about it, on the grounds of protections for our citizens) the Risk Retention Act. We feel that these types of programs may not be the safest alternative.

We are not defending the insurance industry and their lack of support for the market, but we are saying that the Risk Retention

Act and the risk retention groups may not be the safest alternative for our citizens.

In the context of this discussion, looking at risk retention groups, that does not appear to be the problem. The risk retention groups are operating. There are more than 58 of them. There is in fact one in the State of Nevada that operates in ten other states, and so we are very familiar with how those are formed and how they operate.

The real issue seems to be in the area of the purchasing groups, and the issue in the purchasing groups is who is going to control them? The people who will be coming after me today are going to be telling you that there is burdensome regulation, that various states are trying to look at what they are selling, what price they are selling the insurance at, and who is selling it, and what the insurance entity is.

Yes, that is the core of state regulation. That is what we do, day in and day out, and we want to do it in this environment for the purchasing groups because our citizens are the ones who need that assistance. They need somebody who understands the insurance policy. They need somebody who can look at the rating material that is being submitted.

So yes, we would like to be involved in that control of the purchasing group insurer and to point out the necessity for those kinds of things, because essentially what is going to happen now is that we will tell you anecdotal tales of the problems that we see, other people will come after me and tell you anecdotal tales of the problems that they have with the bureaucratic mindset at the state governments.

I am not going to deny that there are bureaucrats in every state and that there are bureaucratic mindsets in some of those environments. We in Nevada are familiar with bureaucratic mindset when you look at the Department of Energy and the issue of Yucca Mountain and the nuclear storage site.

These types of things can be worked on, though, and do not need legislation that would strip any kind of control from the states who are trying to protect their citizens.

Let us take an example of a couple of the different operations that are out there. We have an entity out of Georgia, Victoria Insurance Company, formed and operated more than 30 purchasing groups. The company sold insurance in the area of day care, asbestos abatement, national blood purchasing group, a whole host of very sensitive markets, a whole host of tough insurance markets to place.

The reason that these coverages are not generally offered in the marketplace is not because it is somebody's whim. A lot of times it is because they offer a very tough liability issue.

Just because you remove some of the restrictions on getting these products into the marketplace does not remove the fact that these are tough issues to deal with in the insurance setting.

So we have the Victoria Insurance Company that has $10.5 million in premium, that has records that are so poor that they do not know how many policies that they have sold, that was supposed to have had a $17 million surplus contribution placed in the state which never materialized, and whose board of directors are now not to be found.

And there are approximately $300,000 in assets to deal with well over $10 million in claims that have been identified so far, and more are anticipated.

Another example, out of the State of Louisiana, the New England International Surety of America, which is operating many purchasing groups. This company got into the circumstances where the state came in to look at its financial picture, the company transferred over a million dollars offshore, hired a moving firm, moved 30 or 40 filing cabinets worth of files over to the insurance department, the management quit, and then they left the country.

This is the type of operation that we are concerned with. These are the types of things that we are starting to see.

I can tell you right now that the anecdotal horror stories are going to continue to grow, that the circumstances are such, that the lines of insurance that these people are writing are such that it will be several years yet before the full story is told; and that the proposals that you have one state regulate are illusory protection for the citizens at best and no protection at worst.

Trying to contemplate the circumstance where you have a purchasing group operating outside of the State of New York and going to the New York department, with all the work that they have to do in trying to get them interested in protecting Nevada citizens, is not an environment I would like to contemplate.

I see that my time is up and I will yield to questions at this time.

[The statement follows:]

STATEMENT OF DAVID A. GATES, PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Good morning Mr. Chairman and members of the Committee. I am David Gates, President of the National Association of Insurance Commissioners (NAIC) and Commissioner for the State of Nevada. I am particularly pleased to appear before the former governor of my state and the individual who appointed me as Insurance Commissioner.

The NAIC appreciates this opportunity to offer comments regarding the Federal Liability Risk Retention Act of 1986 (RRA 1986) which amends the Product Liability Risk Retention Act of 1981. The NAIC is a voluntary association of the chief insurance regulators of the fifty states, the District of Columbia and the insular territories. As the individuals charged with the responsibility of regulating the insurance business, we have followed the development of risk retention groups with interest. When the Federal Liability Act was passed in 1986, the NAIC created a task force of insurance commissioners to draft model legislation to implement the federal law. To date, 33 states have adopted the NAIC model and the remaining states are using similar regulatory schemes.

We are aware that drafts have been circulated with proposed amendments to RRA by interested parties. However, it is our understanding that there is no pending bill before this Subcommittee which we should address. Therefore, the NAIC will

comment on issues that we believe to be critical to state regulators in implementation of the federal law.

BACKGROUND

The Liability Risk Retention Act of 1986 basically created a new category of insurer, other than the licensed insurer and the unlicensed but approved surplus lines insurer, which may legally transact business in a state. That category of insurer is a risk retention group, as defined in Section 2(a)(4) of the Act. As we understand it, the intent of Congress in authorizing the formation of risk retention groups was to increase the availability of liability insurance by permitting similar types of risks throughout the nation to form and own their own insurance company to insure their liability exposures. To date there are approximately fifty-nine (59) risk retention groups operating in the United States.

In addition, the Act recognized a separate legal entity called a purchasing group. To put it simply, the purchasing group is a buyer of insurance, the risk retention group is a seller.

As mentioned previously, one aspect of RRA which this Subcommittee may be considering, is whether the Act has achieved its purpose of lessening availability and affordability problems.

It is difficult to measure the impact of risk retention and purchasing groups on availability and affordability as many market and economic factors have played a role in easing the crisis of a few years ago. The critical test to the insurance commissioner is whether risk retention groups and purchasing groups can withstand the test of time as difficult and unpredictable "long tail" liability claims work through the system. Any favorable impact achieved can be largely negated by an illusion of coverage. This concern for sound long term financial protection for consumers will be the focus of our testimony today.

One purpose of the act, simplifying the formation and operation of risk retention and purchasing groups has been met. There have been and continue to be problems with the risk retention groups but as of this date the most troublesome provisions of the act have been in regard to risk purchasing groups.

The federal preemption operates differently with respect to purchasing groups and risk retention groups. Section 3, RRA 1986, provides that a risk retention group is exempt from the laws of non-chartering states, except with respect to those powers specifically referenced, which are retained. On the other hand, Section 4 specifies the laws from which a purchasing group is exempt but permits full application of all other laws to purchasing groups and persons dealing with purchasing groups.

Authority Over Purchasing Groups. The Location Issue.

A key issue of considerable concern to the regulators and to those promoting purchasing groups is the stability and quality of the insurer of the purchasing groups. Significant uncertainty has resulted from the RRA 1986 which states:

> "A purchasing group may not purchase insurance from an insurer not admitted in the state in which the purchasing group is located, unless purchase is affected pursuant to the surplus lines laws and regulations of each state."

The significance of the term "located" is that if a purchasing group is located in multiple states, -- such as in every state where a purchasing group has a member or where there is a risk, the insurance carrier from which the purchase is covered must be admitted in each of those states or must comply with the surplus lines laws of those states.

Many purchasing groups have been formed, a significant number by standard insurers, which was never the intention of the act. Some insurers seem to be insuring purchasing groups exclusively, in fact, one insurer has formed and sold insurance to more than thirty (30) different purchasing groups. Other purchasing groups have purchased insurance from alien and off-shore companies for which it has been impossible to verify even their existence.

This does not imply that the company does not exist or will be unable to pay claims when due, but it does mean that there is no verifiable financial information regarding these companies. The problem becomes even more acute since many argue that the purchasing group insurer must only comply with the laws of the state in which the purchasing group is domiciled.

The opportunity to decide the "located" issue was presented to the federal district in Frontier Insurance Company vs. Hager, CIV.NO. 87-645-E (S.D. Iowa April 27, 1988). The Iowa Insurance Commissioner was sued by several purchasing groups who had made filings with the Department of Insurance. The Iowa Department argued that a purchasing group is located wherever it has individual members. The purchasing groups argued that an insurer for a purchasing group need only be licensed in its state of domicile. The Iowa court in granting the Insurance Commissioner's motion for summary judgement held that allowing states in which purchasing groups are located to require licensing does not stand as an obstacle to the accomplishment and execution of the objectives of the Congress. The court stated that while Congress wanted to facilitate the formation and operation of purchasing groups, the Congress did not divest the states of all their regulatory powers over the insurers of its citizens. The case is on appeal to the 8th circuit and the NAIC will continue to monitor it.

Recent events show these concerns about the solvency of purchasing group insurers raised in Frontier Insurance Company vs. Hager to be prescient.

Victoria Insurance Company, Ltd.

Victoria Insurance Company, Ltd. was formed in May, 1987, in the State of Georgia for the purpose of writing liability coverage for purchasing groups. Within eighteen (18) months the company was the insurer for thirty (30) or more purchasing groups operating nationally even though the company was licensed only in the State of Georgia. Victoria provided coverage for such diverse and high risk groups as the American Lawyers Liability Group, Asbestos Abatement Contractors, Child Care Center Association, National Blood Resources Purchasing Group, and the Nursing Home Association of America.

Georgia laws require a financial examination to be conducted quinquennially but Commissioner Warren Evans, determined to examine the company after one year. He found that inadequate records were available to determine the amount of premium collected, the number of policies issued or the reserves for those policies. Georgia examiners discovered that 10.5 million dollars in collected premium had been removed from the company to foreign bank accounts and that a 17 million dollar surplus contribution was never deposited in the United States. With new

policies and claims coming to light daily, the rehabilitator is facing approximately 10 million dollars in claims with total available assets of approximately three hundred thousand dollars ($300,000). Since the number of policies is unknown and the coverages are "long tail", it is impossible to calculate the eventual damage. Without the purchasing group mechanism this damage could never have reached such proportions in such a short length of time.

New England International Surety of America, Inc.

New England International Surety of America was licensed only in the State of Louisiana but wrote insurance for seventeen (17) or more purchasing groups over the past two or three years. Louisiana Commissioner Douglas Green, met with company officials on April 6, 1989, and because of concerns as to the financial condition of the company, ordered the company to temporarily suspend writing business until certain financial assurances could be verified. Rather than responding to the questions posed by the commissioner, the management of the company transferred one million, ninety-three thousand ($1,093,000) dollars held in a New Orleans bank out of the United States. The officers and board resigned and hired a moving company to relocate thirty loaded file cabinets and ten boxes of records to the Insurance Department of Louisiana.

The department is currently examining the company's files to determine claims and policy holders and has commenced a receivership action to attempt to garner any remaining assets in the country. The company provided coverage to various purchasing groups consisting of asbestos removal companies, diet centers, liquor dealers, and outfitters and guides.

Rate and Form Filings

Two factors that many regulators believe will lead to the results mentioned above are massive marketing efforts to quickly put business on the books coupled with inappropriate policy forms and rates.

The issue of the states authority over rates and form was addressed in Insurance Company of the State of Pennsylvania vs. Corcoran, 850 F.2d 88 (2d Cir. 1988). The United States Court of Appeals, Second District, affirming the judgement of the United States District Court for the Southern District of New York Court held that:

> "Section 4(a)(2) expressly pre-empts only those state laws that prohibit insurers from offering purchasing groups advantages based on their loss and expense experience. It does not purport to prevent state regulators from rejecting a policy form differing from that used for non-members of

purchasing groups or from rejecting a lower rate than is generally available to non-members if these differences are not based on their loss and expense experience."

The Court reaffirmed that the New York rate and form requirements do not prohibit or make unlawful the purchasing group policies offered by the plaintiff in that situation, but only provided a mechanism by which the state can supervise such policies. The recognition of the states responsibility and authority is important since rates should be neither excessive, inadequate, unfairly discriminatory, non-competitive or otherwise unreasonable. There is another lesson to be learned here. This was an admitted insurer which apparently believed that the RRA provided a way for it to remove itself from state control. It argued preemption of state authority to escape any effective supervision.

Conclusion

For those of us who have been involved in insurance regulation for several years, we are experiencing a feeling of "deja vu" when reviewing this regulatory process. We are reminded of the multiple employer trusts which were created under ERISA. I am sure no one wants to repeat the consumer chaos created by the regulatory vacuums of ERISA. At the worst scenario, medical claims were unpaid, providers were suing consumers for unpaid

bills, state regulators were hampered by METS' claims of federal preemption and federal agencies were unresponsive and unable to provide the regulatory oversight that was necessary. We do not want to repeat that scenario.

In Nevada, two hundred and sixty (260) purchasing groups have filed for approval to operate. Not one of the original submissions has been complete. One hundred and thirty-nine (139) of the two hundred and sixty (260) were disapproved because the insurer providing the coverage was unauthorized in the State of Nevada.

The loss experience of the risk retention groups formed pursuant to the 1986 amendments are still years away from maturity. It is anticipated that the lack of competent, experienced management will create many financial problems for regulators and our insurance dependent economy. The low capital and surplus requirements found in some state statutes designed for narrow coverage captive insurance companies but now being used for risk retention groups may exacerbate the problem.

Regulators have been diligent in fulfilling their statutory obligation to protect the consumers in their states within the constraints of RRA. We would caution against eroding the ability or will of the regulator to regulate. To further erode the state regulator's ability to regulate for solvency may pose problems for individual consumers and third-party claimants who find

themselves with coverage from an entity which is insulated from state regulation by federal law and which does not in many instances offer the safety that Americans have come to expect in many financial services products.

In conclusion, insurance commissioners recognize the interest of the risk retention and purchasing groups promoters to operate their programs without interference from numerous state insurance departments. However, as state regulators our job is to protect our citizens. If we must balance ease of operation against claims not being paid because of an insurers insolvency or "unfair" business practices, we must act on behalf of the people. We believe that it is important to maintain and continue this dialogue with members of Congress and other interested parties to assure that the regulators' concerns for solvency surveillance and consumer protections are recognized.

Senator BRYAN. Thank you very much, David.

I understand the historical reservations of you and your colleagues that are state insurance commissioners. But the Congress crossed the Rubicon on that one in 1981 and 1986.

In order to give us some guidance from your perspective, what changes, if any, would you recommend in the Act itself to protect the individual citizens in your state? I have some sympathy for your point of view.

It is not a great consolation to tell the Nevada businessperson who thought he or she had obtained coverage that this company's principal place of business is in New York or wherever it happens to be, and that you will have to defer to the actions of the New York insurance commissioner, who understandably is going to give priority to people who are complaining about problems that arise within his or her state.

But what kind of practical insights can you share with us in terms of making this Act more workable from your point of view and yet achieving the objective that the Congress had in mind in 1981 and 1986?

Mr. GATES. Assuming the objective to be one of providing an alternative insurance market when the normal marketplace is not viable, in that setting I think that if you look at the risk retention groups, that one of the things that would make it easier for us would be to make it very clear that the normal insolvency statutes that we would use would apply even to a risk retention group.

Getting the attorney general in my state, with our workload, to go into Federal district court to try and get an insolvency-based order to stop business operations in our state is very difficult.

The other side of it, I would agree with the Commerce Department: let us make it clear on the issue of locating who has jurisdiction. I would come to a different conclusion, though.

I would make it clear that each state has the ability to look at the rates, to look at the forms, and to look at who is providing that insurance. We have seen some circumstances where people are going out and purporting to sell insurance—we had an entity in Nevada. We went in and got an order to stop the operation of United Business Owners Coalition. It was collecting $200 from the various business operations in the state and purporting to buy all kinds of insurance, including health insurance, and provide it to people.

Given this type of a structure, it is questionable whether we could have stopped that entity. And as far as we know, they never purchased a single thing for anybody, and it is that kind of a problem that we really wish to stamp out.

I recognize that there need to be alternatives for the marketplace, but I think that we have to provide responsible alternatives.

Senator BRYAN. What would your response be to the criticism that some states, with their lack of enthusiasm for the Congressional policy judgment that was made, have erected artificial barriers that are not really premised on the need for protection of the public, which is the observation that you have made and the anecdotal stories that you have shared with us?

What would your response be to that?

Mr. GATES. Aside from the question of "located" because that is at issue at this point, but if you look at the statute and pick out the things that are clearly inappropriate in the state's activities, it is our belief at the NAIC that we would like to be told about those specifics, because we would counsel our brethren and make sure that they were adhering to the statutes.

If we are going to require other people to do what the law requires, then we also must do what the law requires. And in those settings, we have no problem. In fact, we have continued discussions with the various interested groups that would like to have a more lenient environment, to try and identify those things that we agree with them on and identify the states that are not complying with policy set by Congress.

Senator BRYAN. Any other areas of the law that you would recommend that we look at for possible change? Any clarification other than that which you stated previously?

Mr. GATES. I think that the issue of the nature of the insurer needs some clarification. There is a very easy tendency to confuse the insurer of the purchasing group with the purchasing group activity itself.

There are some issues about licensing that I understand that people want to explore, and in those areas we would be willing to explore that also: licensing of the agents and the sales of the products.

Senator BRYAN. Let me ask you your position on another issue. I think the Commerce Department does not support the requirement that agents that are negotiating for or on behalf of the purchasing groups be licensed within the individual states.

What is your position on that?

Mr. GATES. You are talking about an insurance product that is a commercial liability product with someone going out and making a sales pitch with no control whatsoever, only that they be affiliated with the purchasing group. This is the far extreme, as I understand it, of the Department of Commerce's proposal. This concerns me very much, because, as it stands right now, I am concerned about the disclosure of the nature of this type of an entity and the limits on the protections that you get for guarantee funds and other types of protection mechanisms when they are being sold.

To the extent that the citizens understand what they are getting, which I do not believe is the truth in this setting right now, the issue of licensing is very much a concern. However, we would want to make sure that there is no difference between the licensing of a resident and non-resident agent for these kinds of products, as for any other kind of product.

I do not see any rationale for that kind of a distinction or those types of artificial barriers.

Senator BRYAN. Tell us a little bit about your model state law. Some 30 states have now adopted that, have they not?

Mr. GATES. Yes, sir.

Senator BRYAN. How is it working?

Mr. GATES. It seems to be working fairly well if you take our posture and if you go along with the courts in Iowa, that say that the "located" is something that can be determined in each state.

In particular, in Nevada when we adopted the legislation, we adopted a location rule that says that it is for any type of a policy sold in the state of Nevada. So in that context, I believe it is working fairly well.

Senator BRYAN. I see my time is nearly up. Senator Gorton.

Senator GORTON. Back to Senator Bryan's next to the last question on agents. Do you require or do you feel that states ought to be able to require a group of this sort to use agents at all?

Mr. GATES. I think in a certain setting that you should use an agent. If you are talking about a purchasing group who then goes out and makes solicitations and sales, the circumstances of that solicitation and sales and the representations that go along with it, I want somebody to have at least minimal qualifications to do that.

I want to make sure that there is some control over that person, so that they are not making gross misrepresentations.

Senator GORTON. What if the group operates simply by mail?

Mr. GATES. In the setting of operating by mail and if there is a prior approval of the types of mailing or some mechanism to reach that entity if there is inappropriate mailings and representations, in most situations now the insurance departments do not require, especially in the health area—in property and casualty that varies—do not require it to be issued through an agent.

Senator GORTON. What is your recommendation in this connection?

Mr. GATES. In that particular setting—and this would be my personal recommendation; this is not a policy issue that has been decided by the NAIC. In that particular very narrow setting, I think that that would be something where, under appropriate controls, the limitations on requiring it to be done through an agent might not be necessary.

Senator GORTON. Have you stated a reaction to the proposals of the Department of Commerce? Did you see their testimony before you came in here today?

Mr. GATES. No, I did not. We have had discussions with the Department of Commerce, both as to their original report and as to a piece of legislation that they have apparently been discussing, and we have discussed that with them. We feel that their changes would be disastrous and would be very counterproductive to the safeguarding of the citizens of the country.

Senator GORTON. Do you want to expand on that?

Mr. GATES. If you look at what they purport to do, they want to restrict down to one particular state the control over an insurance company. We have had some discussion of the attempt to go to New York and say, while you are fighting all of these other fires in your state, we happen to have a few thousand people in Nevada that we are very concerned about because we think that they have been wronged, we would like you to go and enforce in that environment.

Trying to get a state such as that, no matter how large it is, to go out and be the policeman of the country is going to be problematic.

The other aspect about it is, if you look at the purported solvency protections, where they say that we are going to enhance solvency regulation, they are very much illusory. You get some information, but the areas that you have to go to court and the requirements that you go to either Federal or state courts are a restriction on existing authority that states have now.

I have administrative seizure authority. Although with proper safeguards, I can go in through an administrative order and take control of assets of an entity. My authority, if that would pass, would not be enhanced. It would actually be diminished significantly.

Senator GORTON. I think that is all for this witness, Mr. Chairman.

Senator BRYAN. Thank you very much, Senator Gorton.

I note that we have been joined by the ranking member of the full committee, Senator Danforth. Any questions, observations, insights, wisdom you care to share?

Senator DANFORTH. As usual, I have none, Mr. Chairman. Thank you very much.

Senator BRYAN. We are delighted to have you here with us today.

Senator Kasten.

Senator KASTEN. Mr. Chairman, thank you.

First of all, Mr. Gates, your horror story points up a problem which the Commerce Department already recognized when it proposed more oversight of the insurers or purchasing groups. They said:

> The lack of information on purchasing group insurers jeopardizes regulators' ability to protect the public. If purchasing group insurers were to file the same information as required of risk retention groups, including designation of agent for service of process, to the purchasing group's state of domicile or principal place of business, and file a copy of such information with each state in which the purchasing group is doing business, regulatory oversight would be enhanced.

Now, that seems to me to solve the problem that you were discussing. But it does it in a much better way than having 50 states

exerting more, but more importantly exerting different, regulations of purchasing groups and risk retention groups.

Why is not the information filing once it has been done in one jurisdiction sufficient to solve the problems that you are describing?

Mr. GATES. Well, sir, I guess the question would be one of taking a look at the annual statement, and that is filed with each state that the company does business in generally, and it is also filed with the NAIC. So just about any—over our automated systems, any state will have access to that basic information.

But it is a snapshot and it is a summarization of activities. It will not tell you about the fact that the insurance company does not have a claims processing system, that its records and its management systems are so fouled up that they cannot even tell you how many policies they have issued.

To go back to the basis of insurance regulation at this point, it is that not only do I get information, but I have the independent ability to say that insurance company does not do a good job of protecting its people and it is not going to operate in the State of Nevada.

That is what you are taking away with the Department of Commerce approach. That is what we in our state have done when we have denied purchasing groups operating authority in the State of Nevada.

In some settings we have found that—we have, at least out of the 260 applications or notifications to us, 139 of those were for unauthorized insurers. In addition to that, we had many of those insurers, nine to ten of those insurers, that are not even United States insurers, in violation of the statutes that have been established already by Congress.

Without the ability to go in, to examine further, to delve and to probe the complex business affairs of an insurance company, just merely getting a filing is not going to be sufficient. You have to have that ability to independently evaluate and to independently go in and operate the examination authorities that are present in all the states.

Senator KASTEN. Well, the difficulty is the examination authorities, the forms, and the processing, that differs in each of the states. That is the problem.

Mr. GATES. Not necessarily, Senator.

Senator KASTEN. That goes against what we are trying to do. What is the justification for states all developing different regulation forms, and what is the justification for states requiring these risk retention groups and purchasing groups to provide all of this information in addition to that information which is specified in the Risk Retention Act?

We negotiated back and forth on what kind of information would be required in the Risk Retention Act, and what has happened is that states have not only gone beyond what we were talking about, but they have done it in different ways.

The uniformity concept is one that states are fighting. Now, maybe, everybody wants to be regulating different parts of this, or maybe everybody has some kind of a pride of authorship in their particular state forms.

But the fact is that we are letting these 50 state bureaucracies grind down the spirit of the Risk Retention Act, which was to improve the availability of insurance.

Mr. GATES. Well, again talking about purchasing groups, because that is the environment we are in, I am not quite sure what kind of reports that you are talking about. For the most part, the information that is being provided is information about the financial condition of the company.

But beyond that, it is the insurance company who must file the very specific rate and forms that they are going to use in a particular state. And I think that you can recognize that, if you are going to be talking let us say about malpractice insurance, there is considerable difference between the state of New York, which has a Medical Malpractice Joint Underwriting Association that has had the legislature define it as not being insolvent, although there is a recognized deficit of over $1 billion, closer to $2 billion, if you look at that and then turn to the State of Nevada, where we have enacted certain legislation which has resulted now in our costs of medical malpractice insurance coming down, we have had rate filings just recently of that, that you need that individualized attention based upon the experience in a particular state.

And in addition, the tort climates are different in the various states. Our legislatures have put together different sets of protections for our citizens based upon the needs of the citizens as perceived by them.

That is what causes there to be a difference in the application of the jurisdiction and the controls. It is because we are talking about operating in different environments. It is not one unified solid monolithic environment out there.

Senator KASTEN. Well, I just, I understand what you are saying and I understand that much of what you are saying is under the guise of consumer protection. But the spirit of what we were trying to get at was looking at a job, frankly, different than yours.

We are trying to solve a problem, and it is the worst example of consumer protection. How are we helping consumers by having filing fees anywhere from $50 to $1,000?

A $1,000 fee certainly is not consumer protection. The $1,000 fee and some of these paperwork duplications and redundancies are designed as disincentives.

Is the $1,000 fee under your consumer protection tent also?

Mr. GATES. I would like to have a little bit more information about where that $1,000 fee is being charged and under what circumstances. But I am willing to bet that the $1,000 fee is no different for the purchasing group insurer than any other insurer, and it is probably part of the general economic scheme of that particular state for the funding of its regulatory activities.

Senator KASTEN. Thank you, Mr. Chairman.

Senator BRYAN. Thank you very much, Senator Kasten.

Senator Danforth?

Senator DANFORTH. No questions.

Senator BRYAN. Mr. Gates, we thank you very much for coming. I hope you will be able to stay for the rest of the hearing so that you can respond by mail,with some later questions if we may have them.

Thank you so much.

[The following information was subsequently received for the record:]

NAIC

120 West 12th Street
Suite 1100
Kansas City, Missouri 64105
816 842-3600

National
Association
of Insurance
Commissioners

May 31, 1989

The Honorable Richard H. Bryan
Chairman, Consumer Subcommittee of the
Committee on Commerce, Science, and Transportation
of the United States Senate
SR-358 Russell Senate Office Building
Washington, DC 20510-2804

Dear Senator Bryan:

In response to the additional questions posed in your correspondence of May 8th, the following is submitted.

1. QUESTION: What kinds of complaints, if any, has the NAIC received regarding Risk Retention Groups or Purchasing Groups?

   ANSWER: The NAIC has received numerous complaints from membership regarding problems with Risk Retention Groups and Purchasing Groups. Typically, the complaints in regard to Risk Retention Groups have centered around the lack of adequate capitalization and lack of competent, experienced management. In some states Risk Retention Groups have been formed pursuant to capitalization requirements established for "captive insurers". The theory of captive insurers contemplates a single business concern establishing the captive for its use and writing a limited amount of premium on relatively safe lines of insurance. The use of these statutes by Risk Retention Groups, which often insure complex, "long-tail" coverages, throughout the country, poses a great deal of concern. This type of use of the captive laws was not contemplated and does not seem to be appropriate.

   Further, some states investment and capitalization statutes are more lenient than others. In some instances they permit the Risk Retention Groups to capitalize with letters of credit and other assets which are not considered by other states to be of sufficient quality to insure the protection of policyholders. While we recognize that the purpose of the act was to eliminate just this type of disparate requirement, the limits of the act prohibit the states from inquiring into the nature and quality of the risk retention groups capitalization. The act does not permit the states to protect their citizens by evaluating the solvency of the groups.

Complaints have arisen in regard to rates charged by Risk Retention Groups being inadequate to cover the risk. In one instance, rates for medical malpractice insurance were being utilized without any actuarial certification as to the adequacy. Many Risk Retention Groups have done business in states prior to requesting authority to operate, and it is typical for the Risk Retention Group to delay response to department inquiries and to respond inaccurately.

Complaints regarding Purchasing Groups have been even more numerous. It is apparent that the Purchasing Group mechanism has encouraged the formation or use of undercapitalized insurance companies, compared to the risks being written. The act has permitted these insurers to write tremendous volumes of business in an extraordinarily short period of time. This is especially troubling when you consider that the coverages targeted by this type of program can be a "troubled" coverage that is inherently risky and hard to underwrite.

In some instances, authorized insurers have withdrawn from writing certain lines of coverage on an individual basis, only to reappear as an insurer of the Purchasing Group for the same lines. In one instance, the premium charged to the Purchasing Group member was double that available a short time before on an individual basis. The obvious conclusion was that the insurer utilized the Purchasing Group mechanism in an attempt to avoid state form and rate regulation, not to broaden the availability of coverage.

Then of course there is substantial question of the quality of information provided to the persons solicited by purchasing groups. Purchasing Group members have been sold coverage forms such as claims made policies without adequate explanation of the limitations of coverage and without the ultimate purchaser being aware of the lack of guaranty fund coverage. The solicitation material used by Purchasing Groups needs to be correct in its representations and fully disclose the limitations of the coverage.

2. QUESTION: What are the future prospects for Risk Retention and Purchasing Groups -- that is, do you think the Act will be increasingly used?

-- Is the insurance market likely to harden, so that these will be an attractive alternative?

-- Your testimony refers to the "long tail" of liability, and whether groups formed under the Act can withstand the test of time. What is your evaluation as of now?

ANSWER: If companies are permitted, as would happen under the single-state regulation proposal, to avoid meaningful regulation as to rate, forms, market practices and financial solvency standards, Risk Retention and Purchasing Groups will proliferate. The deregulated nature of these groups gives any company a marketing edge that cannot be ignored. This is particularly true in regard to Purchasing Groups.

Risk Retention Groups may not increase in number greatly until and unless the market in affected lines does harden. Empirical evidence does suggest that the insurance industry is cyclical, however, there does not seem to be an adequate basis on which to predict the lines of insurance most apt

to be involved in a "hard market". It is, therefore, impossible to know if Risk Retention Groups and Purchasing Groups will be seen as attractive alternatives. However, low capitalization and low premiums charged by Risk Retention Groups writing business for various volatile lines such as medical malpractice and asbestos removal does not cause one to be optimistic in predicting whether a Risk Retention Group will withstand the test of time.

3. QUESTION: The Department of Commerce has suggested that primary regulation of Purchasing Group insurers should be limited to the state of domicile or principal place of business. I understand that NAIC does not agree with this suggestion, because it is concerned that other states wouldn't have sufficient information to supervise the insurers.

-- If we were to adopt this change, what kind of information would other states need to protect consumers?

ANSWER: The objection is not based so much on a lack of sufficient information as it is on the lack of oversight and regulation of the insurer. As previously noted, the "one state" approach permits a company to avoid rate and form filings and aggressively market at a rate inconsistent with sound premium to surplus ratios. In addition, guaranty fund coverage will likely not be available to the insureds and the nonregulating state is virtually powerless to investigate and proceed on consumer complaints since in many instances there is not license status to jeopardize.

Ultimately, no matter what the good intentions of the state selected for domicile, it is questionable that the statue could or would put sufficient oversight effort into the monitoring of a purchasing group program that has little if any activity in the state of domicile. Based upon our experience with the insurance industry, the adoption of this standard would be used to escape regulation and the consumers in every state will suffer.

4. QUESTION: Can you explain why states insist upon the use of different formats in obtaining data? Wouldn't it further the purposes of the Act if the states adopted one form?

-- In this and other areas, do you think there is sufficient cooperation among the states in implementing the Act? If not, what improvements could be made?

ANSWER: With regard to information concerning the groups intention to do business in a particular state, the NAIC agrees that a more uniform notice form would be beneficial to both the act participants and to the states. We have worked on this type of approach and will continue to do so.

However, we would oppose the limiting of the states ability to ask questions and obtain additional information. It is one thing to have some uniformity on the material initially filed with a state and quite another to eliminate the ability of the states to follow through on question that arise after review of the material.

5. QUESTION: Under the Act, states can enjoin the actions of a Risk Retention Group which the state believes is in a hazardous financial condition. If Congress were to adopt similar language for purchasing groups, would this be sufficient protection for consumers?

ANSWER: No, Purchasing Groups have no required financial standards since they are not to be risk takers. If the states had authority to enjoin a Purchasing Group thought to be insured with an insurer in hazardous condition, it would not be terribly helpful since in most instances the condition of the insurer would be unknown until too late. Contracts would be in existence and in many situations the financial conditions would not be verifiable by any non-domiciliary state, especially if the Commerce Departments proposals are adopted. The Commerce Department's proposal provides an illusory facade of protection. They purport to allow protection through solvency standards and access to the courts, but it removes existing administrative controls that currently protect citizens of the various states.

6. QUESTION: Some suggest that states impose filing fees as an indirect way of discouraging formation of Risk Retention and Purchasing Groups. For example, I understand that in my home state of Nevada the filing fee is very low, while in other states it is $100 or even higher.

-- What is your response to this criticism?

-- Are these fees being imposed to discourage formation of groups?

-- If not, what purpose does a high fee serve -- that is, does it cover the costs of regulating the groups? If so, why do the amounts of the fees vary so widely?

ANSWER: "High" is a very subjective term. Typically, each state has statutory schedules specifying the fees charged for various filings. The fees charged to Risk Retention Groups are generally the same as those charged insurance companies and vary from state to state. It is difficult to believe that a filing fee of $100 would serve to discourage the formation or operation of a group capable of providing adequate liability coverage to its insureds. Fees are charged for many services and may help to defray some of the expense of processing the filings in some of the states. Some state insurance departments are funded by the fees paid by the industry and other departments are funded out of general revenues. The fees vary because of many factors including the manner in which the department is funded and the philosophy of the entity setting the fees.

7. QUESTION: Does the NAIC have in place a system by which the states can share information about problems with Risk Retention or Purchasing Groups? If so, please describe that system. If not, what could NAIC do to promote such communication?

ANSWER: The NAIC has a committee charged with monitoring Risk Retention activity and problems. This committee serves as the forum for the discussion of specific problems with the Risk Retention Act and groups operating pursuant. In addition, the NAIC maintains a data base called the Regulatory Information Retrieval System (RIRS) which records formal

disciplinary action taken against all insurance agents and companies by the participating states. Finally, and perhaps most important of all, the NAIC provides an advanced (this is our third generation of such a system) computer system that links all states, and as one of its functions it provides "electronic mail" facilities. This allows the states to exchange messages and documents about any subject, including risk retention and purchasing groups.

8. QUESTION: Are there problems with insurance companies, agents or brokers being involved in forming Purchasing Groups? If so, what are those problems? What steps should be taken to counter those problems?

ANSWER: As previously discussed insurance companies frequently utilize the Purchasing Group mechanism to avoid the rate and form filing requirements as well as financial requirements imposed by states to protect consumers. In addition, promoters have frequently been involved in the formation of these groups without any real identity with or concern for the long time interest of the group. The problems are severe but they could be eased by enhancing and clarifying the ability of the state regulator to require the Purchasing Group insurer to be licensed in each state it does business and comply with the laws of that state.

In most states, alternative market insurers such as surplus lines carriers are not permitted to write business when the coverage is reasonably available through traditional "admitted" insurance market. Keeping in mind the purpose of the Liability Risk Retention Act, it would be reasonable to empower the Commissioner to refuse to authorize Purchasing Group operation if coverage is reasonably available through the traditional markets for the lines of insurance to be purchased.

We would be happy to continue to work on additional solutions to these and other problems with your committee. I hope that my comments have been helpful.

Sincerely yours,

David Gates
President
National Association of Insurance Commissioners

Senator BRYAN. Our first panel this afternoon consists of: Mr. Michael J. Mullen, Counsel to the National Risk Retention Association; Mr. David Bossman, President of the American Feed Industry Insurance Company; Mr. James T. McIntyre, Counsel to the Risk and Insurance Management Society; and Mr. Lucien P. Laborde, who is President and Chief Executive Officer for Research and Development of Corroon and Black, representing the National Association of Insurance Brokers.

Gentlemen, good afternoon, and we begin our testimony hearing from you first, Mr. Mullen.

STATEMENT OF MICHAEL J. MULLEN, COUNSEL, NATIONAL RISK RETENTION ASSOCIATION

Mr. MULLEN. Thank you very much, Mr. Chairman.

I am pleased that you have called these hearings on the implementation of the Risk Retention Act. The National Risk Retention Association is an organization of more than 100 members, consisting of risk retention groups, purchasing groups, and others involved in the organization and operation of risk retention ventures.

I am Michael J. Mullen. I am of counsel to the Washington, D.C., law firm of Crowell & Moring, and I serve as legislative counsel to the National Risk Retention Association.

Let me summarize my testimony this way: The Risk Retention Act, even though it has some imperfections that may require clarification, has already benefited many commercial insurance buyers by creating important alternative insurance markets.

There are some 50 risk retention groups and more than 100 purchasing groups. Even though these ventures have been established and are providing important alternative markets, there are some operational problems. Many risk retention groups are faced with varying fees and registration forms which differ from state to state.

Our view is that Congress intended a simple notice filing that would authorize a company that properly complied and completed all the information required under federal law to immediately commence doing business. Yet, many of the states treat these registration forms as a sort of quasi-licensing operation.

Basically, the National Risk Retention Association and its members perceive many of the commercial liability insurance problems as being uniform in nature. That is to say that if you look at the professional liability insurance needs of architects and engineers, of lawyers, or if you look at the needs of businesses such as feed companies that Dave Bossman will testify about, or if you look at housing authorities they have the same general need for commercial liability insurance, regardless of the state they are in.

There may be greater tort liability imposed under the laws of different states, but the insurance coverage that is needed by these groups is fairly uniform.

Our view is that the Risk Retention Act should facilitate the ability of these organizations to create either risk retention groups or purchasing groups and to use uniform policy forms and rates so that they can implement national programs and operate throughout the 50 states.

The way that the states have approached the regulation of risk retention groups is that they still impose, in a number of cases, the same requirements that they do under traditional state insurance regulation. And, as you know, under the McCarran-Ferguson Act, the states are free to establish their own criteria regarding the regulation of insurance companies. This creates various problems if you are trying to create a simple and uniform national program. A small, special insurance company that is required to get its policy forms and rates approved in all 50 states may find that after nine months they are approved in 30 states, but there are still 20 states in which their programs are not approved. That is why NRRA believes there is merit to the idea of having one state review the policy forms.

With respect to the way the states have implemented the Risk Retention Act, the NAIC developed a Model Risk Retention Act, shortly after Congress passed the Risk Retention Amendments of 1986. In its initial Model Act, the NAIC said with respect to the location of a purchasing group, that section 4(f) of the Act "is intended to prohibit them from purchasing insurance from insurers chartered and regulated outside of the United States, unless the purchase is lawfully effected through a licensed agent or broker acting pursuant to the surplus lines laws of that state."

Now, that was NRRA's original understanding of that section of the law and that is what the NAIC said it meant in 1986. Well, subsequently the NAIC changed its views and a number of state insurance departments have changed their views. They now say that a purchasing group is considered to be located in each state and, therefore, the groups's insurance company must be licensed in each state. NRRA sees this as a change in position and a restriction on the scope of the exemption from state laws.

Let me mention one other provision, and that is the provision regarding the insurance contracts and the rates that are used by insurers of purchasing groups. In a drafting note that accompanied the NAIC Model Risk Retention Act of 1986, there is a drafting note—and this appears just after section 7 of the Model Act. It says:

> Therefore, a state can apply all of its laws to purchasing groups, except laws that regulate the provision by an insurer of terms regarding rates, policy forms, and coverages specifically designated for members of the group.

That in our view constitutes a clear statement that the NAIC agreed that rates and policy forms were exempt from state regulation. Subsequently the NAIC and many states have changed their view. They now claim that insurers are required to obtain state-by-state approval of rates and policy forms in all 50 states.

Let me mention just a couple more issues within my brief time. The Act provides that a risk retention group may file copies of the annual reports that are filed in the state in which the risk retention group is licensed as an insurance company. This is set forth in section 3(d)(3) of the Act. Now, some groups are licensed as captive insurance companies and they are permitted to file special captive insurance company annual financial statements. When they file these statements in various states, they find that the states say, we will not accept this financial statement because it is not filed in ac-

cordance with our state's laws for insurance company financial statements. In NRRA's view, the states are wrong because the Act explicitly authorizes the filing of uniform copies of the financial statements in all 50 states. To summarize NRRA's views, we would hope is that some uniform operating rules could be developed so that risk retention groups and purchasing groups can operate under the same uniform rules in all 50 states.

Thank you.

[The statement and questions and answers follow:]

STATEMENT OF MICHAEL J. MULLEN, COUNSEL, NATIONAL RISK RETENTION ASSOCIATION

Mr. Chairman and members of the Committee, thank you for allowing the National Risk Retention Association to present its views on the implementation of the Liability Risk Retention Act and changes that are needed to assure that insurance programs established under this Act may obtain the benefits of simplified regulation that are necessary for the Act to accomplish its purposes. I am Michael J. Mullen, Of Counsel to the Washington, D.C. law firm of Crowell & Moring. I serve as Legislative Counsel to the National Risk Retention Association.

The National Risk Retention Association (NRRA) is a nonprofit organization with headquarters in Washington, D.C., that has more than one hundred members whose purpose is to develop and promote the use of insurance ventures established under the Liability Risk Retention Act. NRRA's goal is to improve the regulatory environment under which risk retention groups and purchasing groups operate. Accordingly, as a principal voice of risk retention and purchasing group organizations, NRRA is pleased to submit this testimony on the implementation of the Risk Retention Act.

I. SUMMARY

The National Risk Retention Association can summarize its position as follows:

(1) The Risk Retention Act -- even though it must be amended to clarify certain regulatory issues -- has already benefited many commercial insurance buyers by creating important alternative insurance markets. For example, the American Feed Industry Association has created a risk retention group which provides liability insurance coverage to

its members, many of whom were denied coverage for feed contamination during the 1980's insurance crisis. More than fifty companies are members of the AFIIC Risk Retention Group.

Another interesting example of the effectiveness of the Risk Retention Act was the decision of the Securities Industries Association to create a risk retention group. Many members of that industry believe that their risks were improperly pooled with banks, savings and loan associations and other financial institutions which had a greater risk of loss than the securities industry. Because commercial insurers had been unwilling to offer more favorable rates to securities brokers, the industry began to organize a risk retention group. After a formal license application was completed and solicitations to capitalize a risk retention group had begun, commercial insurers began offering more favorable premiums to members of the securities industry. Plans to establish the risk retention group were then set aside. This episode dramatically demonstrates that the mere existence of the Risk Retention Act creates a competitive dynamic in which commercial insurance companies are forced to pay closer attention to the concerns of their commercial policyholders.

(2) The Risk Retention Act has led to the formation of at least 50 risk retention groups and more than 100 purchasing groups. These new insurance programs have given their policyholders an important alternative to commercial insurance markets. In many cases, these groups have provided their members with more favorable prices and more attractive policy conditions than are available in commercial markets, as well as the expectation that these ventures will stay in the market during the next insurance crisis. Even in those cases where purchasing group insurers have established programs for markets that disappeared during the recent insurance crisis at rates higher than the pre-crisis rates, they have helped to fill gaps in the commercial markets that were not provided by the traditional non-group insurance products.

(3) Concern has been raised by state insurance commissioners and others that the Risk Retention Act permits or promotes fraudulent or undercapitalized insurance ventures to avoid otherwise applicable requirements of state insurance regulation. First, the National Risk Retention Association does not condone any fraudulent conduct or the operation of any insurance venture that is in a hazardous financial condition, i.e., tending toward insolvency. We do not believe, however, that the Risk Retention Act has caused or led to the promotion of these ventures. All risk retention groups and purchasing groups or their purchasing group insurers must be licensed as an insurance company by the laws of one state (or be authorized to do business in one state) and each state insurance commissioner is authorized to enjoin any activity of a risk retention group or a purchasing group that constitutes fraudulent, false or deceptive conduct, or the operation of a risk retention group or a purchasing group that is in a hazardous financial condition. Further, we have proposed amendments to the Risk Retention Act that strengthen the reporting requirements and clarify the authority of each state insurance commissioner to take appropriate action in any case of fraud or insolvency.

(4) The National Risk Retention Association believes that many commercial insurance buyers find it very valuable to participate as a member of a risk retention group or a purchasing group and obtain coverage under a national liability insurance program that provides uniform coverage and uniform rates or classification system for all members participating in a group. The basic coverage needs of nurses, doctors, and lawyers for an adequate professional liability insurance policy are generally the same across the United States. The same is true with respect to the insurance needs of trucking companies, car dealers, and hardware stores. Their liability coverage needs are substantially similar in all states. Accordingly, we believe that risk retention groups and purchasing groups should be exempt from state

> review of their insurance contracts unless they conflict with a specific statute of a state. With respect to rates, we would note that for physicians there is a greater difference between the rates of physicians in the highest risk categories (brain surgeons and obstetricians and gynecologists) and those in the lowest risk categories (family practice physicians who do not perform surgery), than there is between the average medical malpractice premiums in the lowest cost states and the average premiums in the highest cost states. For this reason, the National Risk Retention Association believes that so long as rates are not so inadequate as to threaten insolvency, they should be exempt from the requirement of approval on a state-by-state basis.

Before I discuss several major problems which have arisen regarding the interpretation of the Risk Retention Act and the exemption of risk retention groups and purchasing groups from state insurance authority, I want to discuss as background the structure of our system of state insurance regulation.

II. BACKGROUND

A. The System of State Regulation

Unlike banks, broadcasters, airlines, railroads, and manufacturers (with respect to labor law and workplace safety), all of which are regulated by federal law, the business of insurance has been regulated almost exclusively by the states. The reason for the system of state regulation is, to some extent at least, historical. In Paul v. Virginia, 75 U.S. 168 (1869), the Supreme Court held that issuing a policy of insurance is not a transaction in commerce. Although this position was affirmed in several subsequent cases, in 1944 the Supreme Court held that the

business of insurance was indeed interstate commerce, and therefore insurance companies could be subject to federal laws, including the antitrust laws. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 523 (1944).

Shortly after this decision the insurance industry and state regulators persuaded Congress that it should reaffirm the policy of state regulation of the business of insurance and provide antitrust immunity to the extent that this business is regulated by state law. This legislation is known as the McCarran-Ferguson Act. 15 U.S.C. § 1011 et seq. (1982). With a few exceptions, including federal riot insurance, federal flood insurance, federal crop insurance and the Risk Retention Act, Congress has left regulation of the business of insurance to the states.

Under the system of state regulation of insurance companies, a company must be organized and licensed as an insurance company in one state, called the company's state of domicile. In order to do business as an admitted -- licensed -- company in other states, the company must apply to be admitted in each of those states. Each state has its own requirements regarding the minimum capital and surplus that a company must maintain before it is licensed to do business. These amounts vary widely among the states. In addition, many states have "seasoning requirements" which prohibit a foreign insurance company (licensed in another state) from doing business in a state unless it has already been in business for a number of years in its state of domicile. See, e.g., Haw. Rev.

Stat. § 431-83(5); Pa. Stat. Ann. § 431-83(a)(5); Vermont Department of Banking and Insurance Bulletin #43, ¶ 6 (May 3, 1989) (all requiring five years of business to be eligible for licensing); and S.D. Codified Laws § 5-6-13(1) (requiring two years).

Third, many states discriminate against foreign (out-of-state) and alien (non-United States) insurance companies by imposing on those companies higher premium taxes than are imposed on domestic insurance companies. Fourth, most state insurance departments require admitted insurance companies to file for approval all policy forms (insurance contracts) and rates that the company intends to use in that state. Fifth, many states have "countersignature laws" that require any insurance contracts issued to persons in the state to be countersigned by a resident agent who must receive some fixed portion of any commission related to that business.

There is in addition to insurance written by admitted companies, insurance provided by non-admitted insurance carriers known as surplus lines insurers. See, generally, J. Ryan, A Background Study of the Non-Admitted Insurance Market (1980). Most state insurance codes provide that a surplus lines insurance company must write business through specially licensed surplus lines brokers. Surplus lines insurers are generally exempt from regulation as to their rates and policy forms. In addition, with the exception of New Jersey, policyholder of a surplus lines

insurer are not protected by a guaranty fund in the event such a carrier become insolvent.

It is also worth noting that most insurance codes exempt transactions occurring in the state relative to policies of insurance involving commercial aviation, ocean marine, railroads and other risks of transportation. Finally, many states exempt the insurance transactions of an "industrial insured" from the state insurance code. An industrial insured is generally defined as a firm having 25 or more employees, a full-time employee who acts as a risk manager, and aggregate annual premiums of $25,000 or more.

B. The Burdens of State Regulation

The system of state regulation of insurance companies imposes substantial and burdensome requirements on a company seeking to do business on a national basis. As this Committee noted in 1981:

> "The principal problems arise not from an inability to create a captive insurance company in one jurisdiction, but from restrictions on the ability of such captives to operate among the several states."

S. Rep. No. 172, 97th Cong., 1st Sess. 3 (1981). For example, the seasoning requirements previously mentioned would prohibit a newly formed captive insurance company composed of chemical manufacturers from becoming licensed to do business in many states until after it had been in operation in one state for at least five years.

A system of state insurance regulation has certain severe disadvantages that make it impossible or very burdensome to establish or modify a national commercial insurance program. As one noteworthy study concluded:

> • A system of state regulation tolerates laws that discriminate against interstate commerce such as agent countersignature laws requiring commissions to be split with local agents, and "seasoning" laws which prevent the entry of new companies until they have been in business for a certain number of years.
>
> • A system of state regulation forces insurers to comply with diverse and conflicting requirements of several states even though the differences in these requirements "are as likely to spring from chance or idiosyncrasy as from meaningful differences in policy or philosophy."

J. Day, Economic Regulation of Insurance in the United States 67 (1970). In this classic study, Professor Day also concluded that state regulation of insurance is inconsistent with the well established fact that insurance needs and problems "cannot be neatly compartmentalized within state lines." Id. at 66. For example, the general liability and commercial motor vehicle insurance needs of a manufacturer with plants and motor vehicles operating in many states are not confined solely to the state in which its headquarters is located. Similarly, an attempt to regulate the liability insurance rates that should apply to a national trucking company by reference to the rates of the state in which it maintains its headquarters may be inappropriate if the company does a large portion of its business outside of that

state. Even many accounting firms, law firms and architects and engineers now carry on national practices, and they may be subject to a malpractice claim far from their home base. It is inappropriate to consider only the professional malpractice insurance rates of these firms' principal place of business because for national firms, claims arising out of work performed in other states may constitute a significant portion of their exposure to professional malpractice liability.

Congress determined that the burdens which are imposed on insurance companies selling insurance to the public at large were not necessary for cooperative self-insurance ventures (called risk retention groups) that are organized solely for the purpose of providing liability insurance coverage to their own members all of whom must be owners of any such special insurance company.

C. The Risk Retention Act

Congress enacted the Risk Retention Act to facilitate the ability of businesses, non-profit organizations and governmental agencies to establish self-insurance pools and to purchase liability insurance on a group basis. The Risk Retention Act is intended to offer additional insurance options regarding commercial liability insurance by authorizing the formation of two types of insurance ventures.

1. Risk Retention Groups

A "risk retention group" is a group captive insurance company or a group self-insurance pool. A risk retention group must be

licensed as an insurance company under the laws of at least one state. A risk retention group, which may only provide insurance coverage to its own members (all of whom must be owners of the group), is exempt from most insurance regulation by states other than the state in which it is licensed as an insurance company. As explained, this is justified because the company does not do business with the public and because it is necessary to exempt a risk retention group from the burdensome and conflicting requirements of state insurance regulation that would, as a practical matter, make it otherwise impossible or impractical to form and operate these insurance programs.

2. Purchasing Groups

The Risk Retention Act also preempts state laws that prohibit insurance buyers from purchasing, and insurance companies from writing, special group liability insurance policies that offer advantages (i.e., more favorable terms) regarding rates, coverage, and other matters. 15 U.S.C. § 3903(a)(2). Although group insurance policies are a common feature of life and health insurance programs, many states have "fictitious group laws" and other laws which prohibit or substantially restrict the right of insurance companies to offer group insurance rates for liability insurance.

For example, the Oregon fictitious group law which is typical, prohibits the sale of "property, inland marine, casualty or surety insurance or any combination thereof, at a preferred

rate or premium to any person based upon a fictitious grouping of that person." Oreg. Rev. Stat. § 737.346(2)(a). Fictitious grouping is defined under Oregon law as a grouping by way of membership, license, franchise, contract, agreement or any other method other than common ownership, or use and control. Oreg. Rev. Stat. § 737.346(1). Under Oregon law which is typical of most states, the limitation on group insurance policies does not apply to life or health insurance. As one major government study concluded:

> [T]hat there are a multitude of unreasonable barriers to the free development of mass marketing of property and liability insurance which are found in the laws of the several states. . . . There is an urgent need to strike down unreasonable barriers in the path of mass marketing so that it may help provide a more adequate and equitable insurance market.

S. Kimball and H. Denenberg, Mass Marketing of Property and Liability Insurance 109 (1970). The study recommended federal legislation to prohibit states from imposing any unreasonable restraint on mass marketing of insurance and group liability insurance programs. Id. at 111.

Because of these anti-group restrictions, even if a trade association has a very strong loss prevention program and provides products or services in a sector of industry that is less risky than other related companies, an insurance company generally cannot provide more favorable rates than it provides to all other insureds in that class. Even more crucial, prohibiting group

liability insurance prevents insurance companies from obtaining the economic efficiencies that can be obtained when writing business on a group basis. Finally, some states prohibit an insurance company from offering policies under a group program at a rate that is more than five percent below the rate for individual policies of substantially similar coverage, regardless of whether there is a basis for the lower group rate. It should be obvious that these laws -- prohibiting group liability insurance coverage -- prevent insurers from offering and prevent businesses from obtaining the benefits of group insurance coverage for their liability risks.

3. The Commerce Department Proposal

In 1979 the Department of Commerce recommended enactment of a Risk Retention Act that provided for the licensing and regulation of risk retention groups by a federal agency. The proposal completely exempted these groups from state insurance regulation. In addition, the Department proposed promoting the sale of group product liability insurance (the 1981 Act was limited to product liability insurance) by exempting purchasing groups from state insurance laws that would prohibit their organization or prevent the groups from obtaining more favorable rates and coverages.

Because of opposition by the National Association of Insurance Commissioners (NAIC), and opposition from insurance company and agent groups, who were opposed to the concept of federal regulation of insurance, a compromise was reached under

which risk retention groups and purchasing groups would be substantially exempted from most of the requirements of state insurance regulation, except in the state in which a risk retention group was chartered, or the state in which a purchasing group was located. This concept -- focusing regulation in one state -- was consistent with the original Department of Commerce recommendation that exempted risk retention groups and purchasing groups from burdensome and duplicative state insurance regulation.

It should be noted, however, that while risk retention groups and purchasing groups are exempt from many state insurance requirements, they must notify each state insurance commissioner if they intend to do business in the state and risk retention groups are required to file a feasibility study and copies of their annual financial statement which must be audited by a certified public accountant and contain a statement on loss reserves from a qualified actuary. Purchasing groups must give notice of their principal place of business, the name of their insurance carrier, and the insurance coverage that is provided to members of the group. In addition, every state insurance commissioner retains authority to enjoin a risk retention group and a purchasing group if: (1) the group is selling insurance to persons who are not members of the group; (2) the group is engaged in any false, deceptive or fraudulent act or practice; or (3) the group, or the insurer of a purchasing group, is in a hazardous financial condition, i.e., it does not have sufficient surplus and

reserves to pay all reasonably anticipated claims that may be made against the group.

4. Countersignature Laws

Countersignature laws require that insurance business produced outside the state be countersigned by a resident agent of the state where the insured business is located. Many of these statutes were enacted at the turn of the century and were intended to provide greater protection to resident insureds. The resident countersigning agent, however, also benefits under the countersignature laws, because in many cases, the countersigning agent must be paid a certain portion of the commission on the business produced. Consequently, these statutes often have the effect of protecting resident agents from competition from out of state agents. The anticompetitive aspects of countersignature laws have been recognized by the federal government. A Department of Justice study on insurance characterized state countersignature laws as "another form of artificial restraint on marketing insurance." United States Department of Justice, The Pricing and Marketing of Insurance 328 n.584 (1977). To its credit, at least one insurance agent association has recognized that "retention of countersignature laws under the present regulatory climate on the state level cannot be justified." Product Liability Risk Retention Act of 1979: Hearings on S. 1789 and H.R. 6152 before the Senate Committee on Commerce, Science and Transportation 96th

Cong., 2d Sess. 201 (1980) (statement of J. David Rowland on behalf of the Independent Insurance Agents of America).

III. RISK RETENTION GROUPS: REGULATORY ISSUES

In general, states have recognized the clear preemption of state insurance regulation under Section 3(a) of the Risk Retention Act, 15 U.S.C. § 3902(a), which provides that "except as provided in this section, a risk retention groups is exempt from any state law . . . [that would] make unlawful, or regulate, directly or indirectly, the operation of a risk retention group." Notwithstanding this exemption from state regulation except for matters specifically authorized by the Risk Retention Act, some states have requested or required risk retention groups to comply with certain regulations that we believe are inconsistent with the exemption established under the Risk Retention Act.

Some states have interpreted Section 3(a)(1) of the Act, 15 U.S.C. § 3902(a)(1), which requires a risk retention group to register with and designate the state insurance commissioner as the group's agent for service of process, as granting them authority to require a group to complete an elaborate registration form and pay a registration fee. These fees have ranged from $50 to $1,000. Because the Act also requires a risk retention group to supply to each insurance department a copy of the group's plan of operation or feasibility study, which must include the coverages, deductibles, coverage limits, rates, and rating classification system for each line of insurance the group intends

to offer, NRRA believes that a state has no authority to require a group to complete additional registration forms describing its business or operations. See, 15 U.S.C. § 3902(d). Moreover, the authority of a state to require a risk retention group to "register" with the insurance commissioner is related "solely" to designating the commissioner as the group's agent for service of process.

Finally, given the sweeping exemption from state regulation, and applying the rule that any state authority that is not listed has not been retained, NRRA believes that a state may not require a risk retention group to pay a registration fee. That is so because the Act specifically provides that a risk retention group may be required to pay applicable premium taxes. 15 U.S.C. § 3902(a)(1)(B). It follows that a state may not require a group to pay a registration fee.

Apart from NRRA's position that states have no authority to require a risk retention group to complete a registration form we think the failure of the National Association of Insurance Commissioners (NAIC) to develop any standard registration form represents a serious failure of leadership because it fails to give the states any uniform guidance on this issue. A central purpose of the Risk Retention Act was to remove the burdens of compliance with multiple state licensing laws. The registration forms and fees introduce through the back door the very burdens that the Act was intended to eliminate. They are troubling on

both legal and policy grounds. NRRA recommends that Congress clarify the Act to expressly prohibit all registration fees and other fees that states have imposed on risk retention groups. Further, NRRA recommends that the Department of Commerce be authorized to develop a standard uniform registration form, if such a form is needed.

A. Annual Statements

Some states have questioned the annual statements of risk retention groups that report the group's financial condition under generally accepted accounting principles (GAP). Because the Act provides an express exemption from state laws and regulations (except as expressly provided under the Act), and because the Risk Retention Act expressly provides that a risk retention group must submit to each state in which it is doing business "a copy of the group's annual financial statement submitted to the state in which the group is chartered as an insurance company," NRRA believes that if a chartering state permits the filing of an annual report under a GAP format, it meets the requirements of the Risk Retention Act. See 15 U.S.C. § 3902(d)(3). NRRA believes that the specific requirements of the Risk Retention Act supersede any additional or conflicting state reporting requirements. The Act should be amended to explicitly authorize GAP reporting when authorized under the law of the chartering state.

B. Letters of Credit

A few state insurance departments have raised questions regarding whether a risk retention group is maintaining adequate capital and surplus if a portion of the group's capital and surplus is in the form of letters of credit. Some states argue that under their laws letters of credit are not recognized for this purpose. NRRA believes that this position is contrary to the plain meaning and general purpose of the Risk Retention Act: to exempt risk retention groups from laws and regulations of states other than the chartering jurisdiction.

The Risk Retention Act permits the insurance commissioner of any state to enjoin the operation of a risk retention group if the group is in a "hazardous financial condition." 15 U.S.C. § 3902(e)(2). Thus, a non-chartering state must recognize the assets of a risk retention group that are credited by the licensing state unless it can be shown that the letter of credit is fraudulent or the bank that issued the letter of credit is itself in a hazardous financial condition. NRRA believes that the Risk Retention Act should be amended to explicitly authorize recognition of letters of credit which are commonly authorized by state captive insurance laws, a form of organization common for risk retention groups.

If individual state insurance departments are authorized to apply their own laws and regulations regarding the recognition of assets of a risk retention group and the adequacy of reserves --

rather than the specifically defined term "hazardous financial condition" -- this would seriously undermine a central element of the Risk Retention Act, i.e., setting an objective, uniform, federal standard for determining if a group is in a hazardous financial condition. Congress set forth a carefully balanced regulatory mechanism for assuring streamlined regulation. Under this scheme the chartering state has primary responsibility for regulation and the insurance commissioners of other states may take action if they determine that a group is in a hazardous financial condition. But, that is to be determined by uniform standards, not the individual rules of a particular state.

C. Credit for Reinsurance

Some state insurance departments have argued that they can deny credit to a risk retention group for reinsurance placed with a reinsurer that is not an admitted or eligible reinsurer in that state. NRRA believes that under the structure of the Risk Retention Act a state is prohibited from denying credit to a risk retention group for reinsurance placed with a reinsurer under a reinsurance agreement that meets the requirements of the risk retention group's chartering state for allowing balance sheet credit for reinsurance ceded.

NRRA believes that the Act should be clarified to expressly recognize credit for reinsurance meeting these requirements. We acknowledge, however, that while such reinsurance should be considered presumptively acceptable, any state insurance

commissioner may enjoin a risk retention group that is in a "hazardous financial condition," and that reinsurance placed with a reinsurer that is itself in a hazardous financial condition may be grounds for prohibiting a risk retention group from doing business in a state. The difference between NRRA's position and that of some state insurance departments is that we believe that the legal authority to enjoin a risk retention group must be found in the Risk Retention Act, not that particular state's insurance laws regarding credit for reinsurance. See 15 U.S.C. § 3902(e)(2) (authorizing each state to seek an injunction against a group that is in a hazardous financial condition).

D. Premium Taxes

A few states have required or requested that risk retention groups pay premium taxes as a non-admitted surplus lines insurer and pay these taxes through a surplus lines broker. NRRA believes that these requirements constitute discrimination prohibited by the Act, 15 U.S.C. § 3902(a)(4), and are inconsistent with the Act's policy of exempting risk retention groups from unnecessary and burdensome state regulation. This requirement discriminates against a risk retention group in three ways. First, surplus lines premium taxes are generally imposed at a higher rate than taxes on admitted insurance companies. Second, any risk retention group that is required to use a surplus lines broker to collect and remit the premium tax will be required to pay an additional commission to that broker. Third, this requirement imposes an

administrative burden on the risk retention group because most surplus lines premium tax forms are different in each state and require a detailed list of the names of each policyholder, the amount of the premium, and the amount of the tax due. In contrast, if the risk retention group is treated as an admitted insurer for tax purposes, it simply files an annual or quarterly tax statement showing the amount of premiums written in that state and the tax that is owed.

In NRRA's view, allowing states to tax risk retention groups at a rate greater than other insurers is not only discriminatory under the Act, it is also constitutionally suspect. In Metropolitan Life Insurance v. Ward, 470 U.S. 869 (1985) the Supreme Court struck down an Alabama tax on gross premiums that taxed insurers organized outside of the state at a higher rate than insurers organized in the state. The court held that this discriminatory tax scheme violated the equal protection clause of the Constitution. Several state courts have reached similar conclusions and have struck down schemes that tax only out-of-state companies or that impose higher taxes on out-of-state or non-admitted insurance companies. See, e.g., Penn Mutual Life Ins. Co. v. Department of Licensing and Regulation, 412 N.W.2d 668 Mich. App. (1987). NRRA believes that the Risk Retention Act should be amended to conform to the practice of the vast majority of states that treat risk retention groups as an admitted insurance company for premium tax purposes.

E. Use and Licensing of Agents

The Risk Retention Act provides that a state may require that a person acting as an agent or broker for a risk retention group must be licensed in any state in which the agent solicits business, but the state may not impose any discriminatory requirements on a non-resident agent. 15 U.S.C. § 3902(c). The Act also provides that a state may not require any insurance policy issued to a risk retention group to be countersigned by an insurance agent or broker residing in that state. 15 U.S.C. § 3902(a)(3). As explained in the Senate Committee Report that accompanied the Act, "this [exemption from countersignature laws] would enable an agent or broker in one State to provide such insurance to members of a group situated in more than one State." S. Rep. No. 172, 97th Cong., 1st Sess. 18 (1981) (discussing Section 4(a)(7), an identical countersignature exemption for purchasing groups).

Notwithstanding these provisions, some states have requested risk retention groups and purchasing groups to engage the services of a resident insurance agent. We are pleased to report these states are in the minority and most have backed down from this position. On the other hand, however, notwithstanding the exemption from countersignature laws many states demand that each risk retention group and purchasing group appoint an agent licensed in that state (either a resident or non-resident agent) if any policies are written on businesses, non-profit

organizations or professionals with their principal offices in that state. NRRA believes that any such requirement is contrary to the exemption from state countersignature laws which was intended to streamline the ability of risk retention groups and purchasing groups to market their programs on a national basis. Moreover, every member of a risk retention group is an owner of this special insurance company, who in many cases has assisted in developing the policy forms and rates for the group's insurance program and has received a 40-100 page Offering Memorandum describing the group, its management, financial projections, and other aspects of the business. It seems to the National Risk Retention Association completely unnecessary to require an owner-investor of a risk retention group to engage the services of an insurance agent to purchase insurance from the company in which this person has just made an investment.

NRRA's position is that if a risk retention group or purchasing group markets its insurance program directly to its members or through a sponsoring trade association it should not be required to utilize an insurance agent. The National Association of Insurance Commissioners (NAIC) recognizes that an agent is not required in these situations:

> For example, currently in the sale of liability insurance under traditional concepts, a particular state may not require a licensed agent or broker to be utilized where a direct offering occurs. Under such a scenario, an insurance carrier directly mails to perspective purchasers general promotional material with an application form which is

> completed and returned with the premium and the utilization of a licensed agent or broker is not required.

Letter from David H. Thornberry, Chair, NAIC Risk Retention Task Force, to Edward T. Barrett, II, United States Department of Commerce (July 28, 1987). Several states exclude direct marketing and the marketing by special insurance companies, which insure only their own members, from agent license requirements. See, e.g., S.D. Codified Laws Ann. §§ 58-30-15 and 18.

NRRA believes that the countersignature and agent licensing requirement of the Risk Retention Act should be clarified to permit direct marketing without the use of agents and to exempt both risk retention groups and purchasing groups from all state countersignature laws. NRRA is aware of the concern of insurance agent organizations about exemptions from agent licensing requirements. We wish to emphasize several points:

1. We agree with agent associations that any independent party (not an employee or officer or director of a risk retention group) who is acting as an agent for the group must be licensed as an insurance agent and an unlicensed person should not be authorized to receive commissions for any business written by the group;

2. We support the efforts of agent associations to gain NAIC approval of the "single producer" license and a streamline system of multi-state licensing of insurance agents;

3. NRRA recognizes the important contribution of insurance agents and the professional services they provide, but we believe that groups establishing national and group liability insurance programs should be authorized to use

streamlined marketing methods to provide coverage to their members at the lowest reasonable prices.

F. Financial Responsibility Laws

Although the Risk Retention Act provides a broad exemption from state laws and regulations, it authorizes states to apply certain enumerated laws. Specifically, the Act provides that subject to the prohibition against discrimination, the Act does not preempt the authority of a state to "specify acceptable means of demonstrating financial responsibility where the state has required a demonstration of financial responsibility as a condition for obtaining a license or permit to undertake certain specified activities." 15 U.S.C. § 3905(d). For example, some state laws require that as a condition for obtaining a license to operate a hazardous waste facility, a person must demonstrate acceptable financial responsibility by means of (1) insurance from an authorized insurer, (2) self-insurance, (3) a surety bond, or (4) by other means. Some states have sought to prohibit insurance coverage provided by a risk retention group from qualifying under their financial responsibility law by arguing that only insurance from an admitted insurance carrier is recognized for the purposes of that law.

NRRA believes that requiring the insurer to be admitted in order to be considered an "acceptable means" of demonstrating financial responsibility ignores completely the anti-discrimination provisions of the Act. Because risk retention

groups may not participate in a state's guaranty fund they are precluded from becoming an admitted insurer under the laws of any state. Surely that cannot be the intent or purpose of granting this authority to the states. NRRA recognizes that if a financial responsibility law requires coverage in a certain amount and requires certain endorsements for pollution risks, for example, then a risk retention group's policy must meet those requirements. But, because many states recognize insurance provided by surplus lines carriers, recognize various forms of self-insurance, bonds, and other means of satisfing financial responsibility requirements, risk retention insurance that provides equivalent protection should be considered to meet the requirements of these state laws.

NRRA is pleased to report that many state insurance departments and motor vehicle departments have not discriminated against risk retention groups and have accepted risk retention policies if a risk retention group demonstrates that it is financially sound, makes arrangements for a surety bond, and agrees to provide both quarterly and annual financial statements.

NRRA believes that the Risk Retention Act should be amended to allow risk retention group insurance policies to meet state financial responsibility laws if the risk retention group meets the capital and surplus requirements of the state in which the policy is issued.

G. Reinsurance of Members

The Risk Retention Act permits a risk retention group to reinsure the similar or related liability exposure of any other risk retention group or its members. 15 U.S.C. § 3901(4)(G)(ii). Some state insurance departments have construed this provision to prevent a risk retention group from reinsuring the risks of its members who have received policies written by an admitted "fronting" insurance carrier. Under a fronting arrangement, an admitted company issues policies in its own name but a substantial portion of the risk is reinsured by a captive insurance company owned or controlled by the companies to whom the policies were issued.

Some state insurance departments argue that a risk retention group cannot reinsure the risks written by a fronting insurance company, it can only reinsure another risk retention group or its members. First, we believe this misconstrues the intent of the language of the Act as it is written. Secondly, we believe it frustrates one method by which several risk retention groups have attempted to meet state financial responsibility requirements. By issuing policies through an admitted fronting insurance company all questions about financial responsibility are met. Accordingly, NRRA believes that the Risk Retention Act should be amended to expressly permit a risk retention group to reinsure coverage written by a fronting company.

IV. PURCHASING GROUPS

A. In General

As mentioned, a purchasing group is any groups of persons which has as one of its purposes the purchase of liability insurance on a group basis. 15 U.S.C. § 3901(a)(5). A purchasing group must be composed of members whose businesses or activities are similar or related and the group may purchase insurance only for its members. 15 U.S.C. § 3901(a)(5)(B) and (C). The premise of purchasing groups is that if similar businesses purchase insurance on a group basis they may present a more attractive market to insurance companies and if the group is large enough it may be able to negotiate more favorable terms of coverage and rates then if insurance was purchased on an individual basis. It is generally true in the life and health insurance area that policies marketed on a group basis are substantially lower in cost than policies issued on an individual basis. The Risk Retention Act is premised on the idea that if it becomes legal to offer commercial liability insurance on a group basis these economies and other advantages may develop.

The purchasing group provisions of the Risk Retention Act are intended to facilitate the availability and affordability of commercial liability insurance by exempting a purchasing group and its insurers from state laws that prohibit offering liability insurance on a group basis. 15 U.S.C. § 3903(a) and (f). Some state insurance commissioners, however, have taken a restrictive

view regarding the scope of a purchasing group's exemption from state insurance laws and their views have been upheld in recent judicial decisions. While NRRA believes that these rulings are incorrect and contrary to the purpose of the Risk Retention Act, there is no doubt that they have encouraged insurance commissioners to impose restrictions on purchasing groups and discouraged some organizations and insurance companies from organizing purchasing groups.

B. The Location of a Purchasing Group

The question of where a purchasing group is "located" is legally significant because if a group is located in only one state -- where it has its offices or headquarters, then an insurance company admitted to do business in that state is authorized, under NRRA's view of the Act, to provide coverage to members of the group located in all 50 states. If on the other hand, a purchasing group is "located" in every state in which any policyholder insured under the group's program resides, then the purchasing group's insurer must be an admitted carrier (or an eligible surplus lines insurer) in each of those states. Section 4(f) of the Risk Retention Act sets forth the requirements for a purchasing group insurer:

> A purchasing group may not purchase insurance from . . . an insurer not admitted in the State in which the purchasing group is located.

15 U.S.C. § 3903(f) (emphasis added). A federal district court in Frontier Insurance Co. v. Hager, No. 87-645-E (S.D. Iowa,

April 27, 1988), concluded that contrary to its plain meaning, Section 4(f) did not provide the exemption from state licensing laws for insurers of a purchasing group. NRRA believes that the court misconstrued the plain meaning of the Act and has filed an amicus curiae brief supporting an appeal of this decision. That action is now pending before the Eighth Circuit Court of Appeals.

NRRA believes that when Section 4(f) speaks of "the state in which a purchasing group is located" it refers to a single state. We believe that the legislative history and background of the Risk Retention Act Amendments of 1986 support this position. First, Section 4(e)(2), 15 U.S.C. § 3903(e)(2) exempts from registration any purchasing group which was established prior to the enactment of the 1986 Amendments if, among other things, the group has continuously "purchase[d] its insurance from an insurance carrier licensed in any state." 15 U.S.C. § 3903(e)(2) (emphasis added). This shows that Congress considered any previously existing purchasing group whose insurer was licensed in a single state to be qualified to insure a purchasing group. This is consistent with NRRA's views, and generally accepted principles of insurance law which do not apply a states' insurance code to the transaction of business by an unlicensed insurance company that involve a group policy "lawfully issued and delivered in a state where the insurer was licensed to transact the business of insurance." See, e.g., Va. Code § 38.2-1039.D.4.

Second, Section 4(e) (which was added by the House of Representatives after Section 4(f) had been incorporated into the Act by the Senate) requires a purchasing group to register with "each state in which it does business." See 15 U.S.C. § 3903(e). If the House of Representatives intended to require the insurer of a purchasing group to be an admitted insurer or an eligible surplus lines carrier, it could have amended Section 4(f) to require the insurer to be admitted in each state in which any member insured by the purchasing group is located. But, neither the House, nor the Senate when it considered the 1986 Amendments for a second time, made any such change. Therefore, NRRA believes that the plain meaning of the phrase "the state in which a purchasing group is located" should be applied and that an exemption from state licensing requirements should be recognized if the insurer of a purchasing group is admitted or is an eligible surplus lines carrier in the state where the purchasing group has its headquarters or offices. It is worth noting that the original NAIC Model Risk Retention Act published in 1986 did not treat a purchasing group as being located in each state. Rather, it commented (correctly we believe) that "the purpose of this restriction [Section 4(f)] on insurance purchased by purchasing group is to prohibit them from purchasing from insurers chartered and regulated outside of the United States, unless the purchase is lawfully effected through a licensed agent or broker acting

pursuant to the surplus lines laws of that state." NAIC Model Risk Retention Act § 9 (Drafting Note) (1986).

We note that the United States Department of Commerce has recommended that the Act be clarified to provide that a purchasing group be treated as the resident of a single state, the state in which it maintains its principal place of business. See Liability Risk Retention Act of 1986: Implementation Report 92 (U.S. Department of Commerce, September, 1987). NRRA supports an amendment to the Act to expressly define a purchasing group's "principal place of business."

NRRA appreciates the concern of the NAIC and its member insurance commissioners that inadequately capitalized unlicensed insurance companies might attempt to undertake risk retention programs which they are not capable of managing in a safe and sound manner. To address this concern, NRRA has included in its proposed Risk Retention Amendments, which we are submitting with our testimony, a proposal to require minimum capital and surplus requirements for any insurer of a purchasing group, that such a company be licensed as an insurer in at least one state or be on an approved NAIC list of alien (non-U.S.) companies, and that these insurers file annual financial statements that are certified by a CPA and include a statement on loss reserves from a qualified actuary. We believe that these measures will adequately address concerns about solvency without subjecting purchasing group

insurers to unduly burdensome and conflicting state insurance regulations.

C. Policy Forms and Rates

The Risk Retention Act provides that a purchasing group is exempt from any state law that would make it unlawful for an insurer to provide or offer to provide insurance on a basis providing, to a purchasing group or its members advantages based on their loss and expense experience, not afforded to other persons with respect to rates, policy forms, coverages or other matters. 15 U.S.C. § 3903(a)(2).

1. In General

Unfortunately, the United States Court of Appeals for the Second Circuit held that the Risk Retention Act did not exempt an admitted (licensed) insurance company providing coverage to a purchasing group from state policy form and rate regulation. Insurance Company of State of Pennsylvania v. Corcoran, 850 F.2d 88 (2d Cir. 1988). While rejecting State of Penn's argument regarding the exemption from rate and form filing regulations, the Court acknowledged that: "State of Penn may be correct that the RRA's preemption provisions are so narrow that Congress' general goal of increasing the availability of liability insurance to purchasing groups will only be partly achieved." 850 F.2d at 93. In effect, the Court recognized the force of the arguments advanced by State of Penn regarding the background of the Risk Retention Act and the practical consequences of accepting the insurance department's narrow construction of the exemption from

state insurance regulation. The court seemed to invite the National Risk Retention Association and other parties to go back to Congress to obtain a more explicit exemption from state policy form and rate regulation. And we now do so.

In NRRA's view, the Court's decision overlooks the structure and background of the Risk Retention Act. It gives a technical and narrow meaning to Section 4(a)(2) that substantially nullifies the usefulness of the Risk Retention Act for purchasing groups that are insured by admitted insurance companies. For example, the Senate Report that accompanied the 1981 Risk Retention Act explained that the purpose of Section 4(a)(2) was to "preempt state laws which restrict or hinder the creation or operation of safety groups or other arrangements to take advantage of mass marketing programs of any insurance company. . . . This paragraph contemplates that a group might be afforded advantages over the general public based on its unique loss/and or loss expense experience, with the advantage taking the form of rate reductions [or] changes in policy forms." S. Rep. No. 172, 97th Cong., 1st Sess. 4, 17-18 (1981).

The very purpose of the purchasing group provisions of the Risk Retention Act is to create the legal authority for these groups to negotiate more favorable terms regarding rates and coverages "without imposing on them conflicting requirements in each State in which they operate." 132 Cong. Rec. S9229 (daily ed. July 17, 1986) (statement of Sen. Kasten). The NAIC itself

originally agreed with our position. A drafting note which accompanied its first model Risk Retention Act stated:

> Therefore, a state can apply all of its laws to purchasing groups and persons dealing with purchasing groups (except laws regarding formation and the provision by an insurer of such terms regarding rates, policy forms and coverages specifically designated for members of the group).

NAIC Model Risk Retention Act § 7 (Drafting Note) (1986).

What happened? In NRRA's view, several state insurance departments concluded that the exemption from state regulation provided under the Risk Retention Act and the original NAIC Model Act was too broad. They pressured the NAIC to modify its Act (which it is their legitimate right to do) and they have continuously issued additional regulations to restrict the authority of purchasing groups and their insurers. This has led to litigation, burdensome paperwork requirements, and uncertainty about the scope of exemption of purchasing groups from state insurance laws.

2. Policy Forms

Section 6(a) of the Act provides that the Act shall not be construed to exempt a purchasing group from any policy form or coverage requirements of any state no-fault insurance law. 15 U.S.C. § 3905(a). Section 6(c) further provides that the terms of any insurance policy provided to a purchasing group may not include coverage that is prohibited generally by state statute or that has been held to be unlawful coverage by the highest court of

the state whose law applies to that policy. 15 U.S.C. § 3905(c). NRRA believes that these two provisions demonstrate the clear intention of Congress to provide a general exemption of purchasing group policies from the requirements of state-by-state approval, except with respect to no-fault motor vehicle coverages and coverages that are clearly unlawful under a state statute. There would have been no purpose for Congress to include these sections in the Act if its intent were otherwise; i.e., if the insurer of a purchasing group was required to apply for state-by-state approval of its policy forms. Notwithstanding this rather clear purpose, the New York Insurance Department (on the basis of the decision in State of Penn) and many other state insurance departments require insurers to file all policy forms for purchasing group for approval.

This has a very detrimental effect on purchasing group programs because, in general, these programs are established by negotiations between a sponsoring trade association or professional society, an insurance broker and a underwriter. They agree on the scope of the coverage, any special endorsement tailored to the group's needs, those exclusions which are acceptable and justified for the particular risk, and a rate schedule that will produce sufficient premiums to pay the reasonably anticipated claims, expenses and commissions. If each state insurance department is free to exercise broad discretion with respect to the wording of the policy forms, the coverage and

the exclusions, the changes they require have effect of breaking up -- balkanizing -- the uniformity of a group program and throwing a monkey wrench into the assumptions that the actuaries and underwriters have made about the rate schedule. If a state insurance department requires rewording of the policy or an endorsement that increases the exposure, the underwriter must adjust the rate to take into account this increased exposure to risk. In NRRA's view, such balkanization of purchasing group programs substantially impairs their utility and, in our view, is completely contrary to the intent of Congress as set forth in Sections 6(a) and (c).

Let me emphasize two points. First, as I stated in my earlier remarks, the basic coverage needs of professionals such as lawyers, doctors, architects are largely similar throughout the United States with respect to the scope of the coverage that is needed to provide them with a reasonable or adequate professional liability insurance. Similarly, the scope of the coverage as defined in an insurance policy is generally the same for automobile dealers in most states. And in NRRA's view, unless there is some coverage that is mandated by statute, purchasing groups should be free to develop a common policy form applicable to all of the group's members in all 50 states. Second, NRRA recognizes the concern of state insurance departments regarding sham policies or unconscionable policy terms. We would not object to the right of a state insurance department to prohibit the use

of any policy form that is fraudulent. In fact, the amendments to the Risk Retention Act that we have proposed explicitly provide for the authority of any state insurance department to take action against any false, fraudulent, or deceptive activities by a purchasing group or its insurer. We believe this will give adequate protection to the members of the purchasing group without impairing the authority of the group to develop uniform national coverage.

D. Other Purchasing Group Issues

Purchasing groups face the same problems as risk retention groups with respect to the use of direct marketing and the requirements for agents to countersign policies, problems with premium taxes, as well as serious problems with respect to burdensome registration forms and registration fees. NRRA would reemphasize the problems explained earlier in our earlier testimony, and urge this Committee to consider our recommendations for amendments to address these problems.

V. CONCLUSION

The National Risk Retention Association believes that despite its imperfections, and despite the sometimes unwarranted interference from state regulators, the Risk Retention Act has been an important factor in the development of alternative insurance markets. This can be illustrated by looking at an example of the difficulty experienced by one insurance agency in

its attempt to establish a group liability insurance program before the enactment of the Risk Retention Act.

> So we tried to put together a safety group. It took us almost two years to get approval from the insurance department to fashion it the way we wanted to. (But) by the time we got the approval, the market that had agreed to do it had dried up. Our reinsurance fell through primarily because of the unwieldeness of the regulations we had to cut through.

Insurance Review, April 1989 at 32 (statement of Tommy Dietz, Insurance Agent). As we have demonstrated in our testimony there are, in spite of the Risk Retention Act, many different, conflicting, and burdensome requirements that states attempt to impose on risk retention groups and purchasing groups. We believe many of these requirements conflict with the basic purposes of the Risk Retention Act.

We also recognize, however, the need for adequate regulation of solvency, adequate reporting of a company's financial condition and its business activities, and adequate authority to deal with fraud and other false and deceptive acts or practices. Accordingly, the National Risk Retention Association has developed proposals to clarify the Risk Retention Act that will provide a bright line between those activities which are exempted from state regulation and those activities that remain subject to state regulation. In addition, NRRA proposes that minimum financial standards be established for any insurer of a purchasing group and that these insurers meet strict requirements regarding their annual financial statements. In addition, we support clear

authority for insurance commissioners to deal with any false, deceptive or fraudulent conduct.

The National Risk Retention Association has submitted its proposals to the National Association of Insurance Commissioners, insurance company trade associations, agent trade associations, the National Association of Insurance Brokers, and the Risk and Insurance Management Society. We have held several meetings with each of these organizations to obtain the benefit of their views as to how the Risk Retention Act can be constructively amended. NRRA believes that only through clarification can the Risk Retention Act fulfill its potential for permitting the development of alternative insurance markets.

Mr. Chairman, the National Risk Retention Association commends you for calling these hearings regarding the implementation of the Risk Retention Act and appreciates the opportunity to present its views.

QUESTIONS FOR THE NATIONAL RISK RETENTION ASSOCIATION FROM SENATOR GORTON

1. *Amendment of the Risk Retention Act in 1986 was prompted in part with problems with cost and availability of liability insurance. Is there still a need for alternative sources of insurance such as risk retention groups and purchasing groups?*

In NRRA's view, there is a vital need for alternative insurance markets and a vital need to clarify the extent to which risk retention groups and purchasing groups are exempt from state insurance regulation. Although insurance markets have "softened" substantially since 1986 and this has brought about a greater availability and more reasonable pricing of liability insurance, in NRRA's view there are still many niche markets in which the legal authority to create group liability insurance programs under the Risk Retention Act is extremely valuable.

For example, there is still restricted availability of insurance for professionals such as nurse practitioners. There is still a restricted market for day care insurance. Many professional liability insurance programs including lawyers' malpractice, title insurance agents, real estate agents, and others have been established under the Risk Retention Act. In addition, risk retention groups established for feed industry companies, for medical device manufacturers, and for the liquor liability of restaurants and beverage distributors have given companies in these industries a valuable alternative insurance market. In our view, the legal opportunity to create a risk retention group can spur commercial insurance companies to develop better insurance contracts and more reasonable prices for liability insurance coverage. In NRRA's view, the Risk Retention Act should be maintained and clarified because when another hard market and high prices and restricted availability of insurance occur, it will be very important for businesses and trade associations to have available the legal opportunity to create alternative insurance programs.

QUESTIONS OF SENATOR BRYAN FOR MICHAEL J. MULLEN,
REPRESENTING THE NATIONAL RISK RETENTION ASSOCIATION

Q: Your testimony addresses a number of areas in which you claim the states have interpreted this Act so as to thwart its purposes.

-- Though you have suggested them, are legislative amendments necessary to clarify these points? Wouldn't a different, more receptive approach by state insurance regulators obviate the need for legislative fixes? If not, in what areas would legislation still be needed?

A: If all -- and I emphasize all -- state insurance commissioners were receptive to the National Risk Retention Association's views on appropriate state regulation under the Risk Retention Act, that well might obviate the need for additional legislation. But, experience has led NRRA to believe that the likelihood that all state insurance departments will adopt a positive approach towards the Risk Retention Act is remote. For example, following enactment of the Risk Retention Act in 1981 the NAIC adopted a model Risk Retention Act containing a definition of product liability directly at odds with the definition contained in federal legislation. This was done for the purpose of aiding one state insurance department in attempting to close down the only risk retention group then in operation. Fortunately, Congress adopted a technical amendment to the Risk Retention Act in 1983 and a federal court denied the state insurance department's claim that this risk retention group did not provide product liability insurance coverage.

Further examples of restrictive positions about the Risk Retention Act are included in NRRA's testimony. I will mention three: (1) after first recognizing that the "location" test for a purchasing group was intended only to screen out alien insurers not authorized to do business in any state, the NAIC later supported the position of the Iowa Insurance Department that a purchasing group is located in each state; (2) after stating in its 1986 NAIC Model Risk Retention Act that policy forms and rates of an insurer providing coverage to a purchasing group are exempt from state regulation, the NAIC switched its position and supported the New York Insurance Department in litigation requiring the filing and approval of all rates and policy forms; and (3) although the NAIC stated in a letter to the Department of Commerce that "direct offering" of insurance without the use of insurance agents is an accepted marketing method, many state

insurance departments require risk retention groups and purchasing group to retain the services of an agent licensed in that state. These examples as well as the recognition of letters of credit, the acceptance of annual financial statements filed in the chartering jurisdiction, and other matters led NRRA to believe that legislative amendments clarifying these issues are essential. NRRA believes that each of the legislative recommendations contained in our draft legislation (which accompanied our testimony) should be adapted by Congress to provide clear rules regarding the operation of risk retention groups and purchasing groups.

Q: I would like to identify the potential insolvency of an insurer as one of the greatest concerns I have about the implementation of the Act. NAIC identifies that issue as a factor behind its desire to obtain information about groups, and NAIB also mentions that concern.

> *-- Do you believe that sufficient authority exists under the Act in this area? If so, please explain why you believe that, if not, please identify what provisions you might suggest.*

A: NRRA believes that there is sufficient authority under the current Risk Retention Act for state insurance departments to obtain information about the insurers of purchasing groups and to take legal action against groups which are insolvent or are in a hazardous financial condition. In fact, we understand that the California Insurance Department has obtained a cease and desist order against the insurer of a purchasing group which that Department believed was in a hazardous financial condition. Because there is some uncertainty over state authority to investigate and impose sanctions against purchasing group insurers, however, the National Risk Retention Association supports amendments to the Risk Retention Act to explicitly require insurers of a purchasing group to provide copies of their annual financial statements to each state in which they are doing business, to permit each state to initiate an examination of a purchasing group insurer, if the domiciliary state has not initiated such an examination, and to explicitly authorize each state to seek a court injunction against any purchasing group insurer that is insolvent or in a hazardous financial condition. NRRA believes these proposals constitute a direct response to any concerns about regulation of solvency.

Q: The Risk Retention Act was established to create alternatives to the traditional insurance market. You testified that it has

succeeded, to some extent at least, in this regard. Specifically, in what ways does NRRA feel that the Act has had the most impact on the insurance marketplace?

A: As indicated in our testimony, the two most important ways in which the Risk Retention Act has succeeded are: (1) By permitting 50 risk retention groups to provide coverage that members of these groups found to be inadequate in terms of coverage or unaffordable in terms of price, prior to the formation of these groups. Purchasing groups have also provided the opportunity for many businesses and professionals to obtain coverage that was not available from traditional markets during the mid 1980's, and (2), the Risk Retention Act, by virtue of "potential competition" with traditional insurance markets, has forced commercial insurance companies to be more responsive to the particularized risks and particularized coverage needs of commercial insurance buyers. This is illustrated by the response of the commercial insurance markets to the efforts of the Securities Industry Association to create a risk retention group, which I discussed in my testimony.

Q: You interpret the Act to preclude a state from imposing any registration fee. Do you object to all fees, even those that could defray administrative costs, or is it just high fees that you resist?

A: In NRRA's view, a state should be prohibited from imposing any registration fee or other fees on a risk retention group or purchasing group. The Risk Retention Act is very explicit in providing that a state may not prohibit the formation or operation of risk retention groups or purchasing groups and that these groups are required to register with a state insurance commissioner "solely" for the purpose of appointing the commissioner as the group's agent for service of process. If the purpose of the Risk Retention Act in exempting these groups from state-by-state licensing is to be accomplished, it is necessary to exempt them from registration fees which are merely a substitute form for licensing fees. It is our understanding that a registration fee of $1,000 proposed by the State of Alaska is the same amount imposed upon licensed insurance companies.

In NRRA's view, the administrative burden imposed upon states under the notice filing by risk retention groups and purchasing groups does not justify any registration fees. These groups, or the insurers of purchasing groups are obligated to pay required premium taxes which should defray the administrative costs related to operating a state insurance department.

Q: Your testimony refers to the question of "location" of a purchasing group, and urges that the Act be interpreted to mean a single state where the group has its principal place of business. Your also suggest minimum capital and other requirements so that a state has sufficient information to oversee the adequacy of purchasing group insurers.

> *-- Suppose that the state where the group has its principal place of business is not very vigilant about its regulation of the insurer. How are members of the group in other states protected?*

A: In NRRA's view, under current law any state in which a purchasing group insurer is doing business is subject to investigation and appropriate sanctions if it has engaged in any fraudulent conduct or it is in a hazardous financial condition. Moreover, under the amendments proposed by the National Risk Retention Association a purchasing group insurer is required to provide copies of its annual financial statement which must be certified by a CPA and contain a statement on loss reserves from a qualified actuary. This information, complemented by the explicit authority of each insurance department to take action against fraudulent conduct or companies operating in a hazardous financial condition, will in NRRA's view, provide adequate protection to policyholders in each state. Moreover, if a purchasing group insurer is a "non-admitted" company not within the protection of a state guaranty fund, a state may require a purchasing group insurer to provide clear notice of this fact to each policyholder covered by a purchasing group.

Q: If an agent organizes a purchasing group, can that group obtain the best insurance arrangement possible, or is there a conflict of interest in this relationship? In other words, should there be a prohibition on agents forming such groups?

A: There is a potential conflict of interest if an agent organizes a purchasing group, but we do not believe a per se prohibition on such arrangements is necessary or desirable. First, even if an insurance agent organizes a purchasing group for a trade association, so long as the trade association has the right to reject any insurance carrier or rating plan which the agent proposes to the group, there is nothing improper about any assistance the agent may have provided in organizing the group. Second, apart from the Risk Retention Act many insurance agents some of whom exclusively represent a single carrier, organize group insurance programs. In our view, so long as an agent does not fraudulently misrepresent his or her interests, or

fraudulently steer business to an undercapitalized controlled insurer of the agent, we see nothing illegal or unethical regarding assistance by insurance agents, brokers or insurance companies regarding the formation of purchasing groups. On the other hand, if the purchasing group is totally controlled by an agent or insurer and acting as its alter ego, then circumstances might arise in which disinterested advice was not available to the group. In our view, agents and brokers should not be prohibited from assisting in the organization of purchasing group, but rules should be established to assure full disclosure and fair dealing between groups and their agents.

Q: As I understand it, you suggest that if a group markets its insurance directly to its members, it should not be required to utilize an agent.

-- Is this because you feel that members should know what they are getting into? Doesn't this presume a fair amount of sophistication on the part of members, particularly purchasing group members?

A: First, we believe that risk retention groups and purchasing group insurers should be authorized to make a "direct offering" of insurance because the NAIC has recognized such practices are authorized under current practice. (See the NAIC letter of July 28, 1987, quoted in NRRA's written testimony.) The problem that risk retention groups and purchasing groups have experienced is that some states do not agree with the NAIC's position and the generally accepted practice. Second, many life and other insurance products are marketed by direct mail offerings.

We do not assume that all members of a purchasing group or risk retention group are highly sophisticated insurance buyers, but we do assume that they have more knowledge or access to more knowledge about commercial liability insurance needs than a person purchasing private passenger automobile insurance. Most doctors belong to medical societies, most lawyers belong to state and national bar associations, and most businesses belong to various trade associations that either provide direct educational materials or have in-house experts or legal advisors who can be contacted regarding insurance issues. Moreover, each state insurance department will retain authority to take action against any false, fraudulent or deceptive practices in connection with the direct offering of risk retention group or purchasing group insurance coverage. NRRA believes that this will give adequate protection to commercial insurance buyers.

We recognize the interest of agents in preserving their professional role in the marketplace. But we also believe that insurance buyers should have the opportunity to purchase insurance through different marketing methods, if they wish to do so. This is particularly true in the case of a risk retention group. NRRA does not think an investor who has reviewed a business plan and invested substantial sums in an insurance company (the RRG) should be required to consult an agent about the purchase from the company in which he or she has an ownership interest.

Q: You have proposed that minimum capital requirements, insurer licensing and annual financial statements be filed in each state where a purchasing group does business.

-- Why do you feel that these kinds of requirements will be a sufficient guard against insolvency, a problem that unfortunately has been demonstrated recently?

A: NRRA believes the minimum capital requirements included in its proposed amendments for purchasing group insurers will provide an adequate safeguard against insolvency if state insurance departments receive these report give adequate scrutiny, and take action in appropriate cases. It is important to note that the minimum requirements of $3 million in capital and surplus is greater than the minimum capital required for a monoline (single coverage) insurer under the laws of many states. In addition, the requirement that the annual statement be certified by a CPA and contain a statement on loss reserves by a qualified actuary are not presently included in the laws of many states. Accordingly, we believe these minimum standards will actually set a higher standard for financial reporting than is required under the laws of many states.

Senator BRYAN. Thank you very much, Mr. Mullen.
Mr. Bossman.

STATEMENT OF DAVID BOSSMAN, PRESIDENT, AMERICAN FEED INDUSTRY INSURANCE CO.

Mr. BOSSMAN. Thank you, Mr. Chairman and members of the subcommittee.

I am David Bossman, President of the American Feed Industry Insurance Company Risk Retention Group or AFIIC. We were formed as a risk retention group on July 1, 1987, under the 1986 amendments to the Risk Retention Act. AFIIC insures the product and general liability risks of 56 companies in the livestock feed industry. Those companies range in size from a million dollars in sales to over a billion dollars in sales.

AFIIC was formed because during the hard insurance markets many of the traditional insurance carriers dropped the coverage for feed manufacturers. In the midst of the 1986 hard market, the members of the American Feed Industry Association, which is the national trade association for the feed industry, they asked us to see what could be done to assist them in providing insurance coverage.

Initially it was assumed that we would form an offshore captive company for the feed industry. While in the midst of our feasibility study, the 1986 amendments were made to the Act.

We determined that we would qualify or could qualify as a risk retention group under the amended Act. After performing a domicilary search, we selected Iowa because of its geographical importance to our industry and its well-respected insurance department.

In our formation process, we found several provisions of the Risk Retention Act which became very burdensome. The most difficult hurdle was the capitalization of the insurance company. Prior to selling insurance, a corporation has to be formed with a myriad of corporate legal documents, all costing a great deal of money, enough to send the first-born of the finest lawyers to their universities.

Once the corporate filings were completed, the capitalization of the insurance company became a chicken or egg dilemma. We had to persuade potential insureds to purchase stock in the company before they could buy insurance and before they knew if the insurance company would even be authorized to write their coverage.

If the Act could be modified to allow a short passage of time between the owner-insured and the insured-owner requirement, it would allow for initial third party funding, which would certainly assist in the formation process.

We were able to leap the chicken or egg hurdle by having trust in the leadership formation team and by condensing the time of our corporate filings to the insurance company authority down to 60 days. But believe me, it is very difficult to call your potential insureds and shareholders and ask them to send you by return mail $4 million, and if it does not work out all right I will just send it back to you. That is very difficult.

The key section of the Risk Retention Act which persuaded us to foresake the beaches of Bermuda for the corn fields of Iowa was

the notification filing provisions. AFIIC could not exist if we were required to be a licensed company or an approved surplus lines carrier in all states.

We understood that Congress intended that as a risk retention group we would only have to notify the other 49 states that we are alive and well in Iowa, and if the other states wanted more information all they would have to do is call the Commissioner, Bill Hager, or his deputy, and they would verify that we were legitimate and so you do not have to worry about those feed folks.

Well, Mr. Chairman and members of the subcommittee, I am going to report that the results of that were just a little bit mixed.

After the notification filing of our business plan, which is what this document was—and we sent it to all of the other 49 states—we were confronted with reactions from "cease operations or your insureds are going to lose their license to do business," to absolutely no response at all, to a host of different kinds of "send money" requests.

Fourteen different states sent applications or registration forms or filing forms, varying in length and complexity from one page to eight pages. All requests were basically for the same information which was already sent in the business plan.

Each of the states that asked for a form also had a filing fee, and that ranged from $100 to $1,000. Nine states asked for additional financial information, and that was a whole host of different things. Eleven states asked us to appoint an agent or a surplus lines broker, even though we market only through the efforts of the trade association.

One state persistently required us to join their joint underwriting and their market assistance plans, even though we had no use or could not use them.

We have not and have received no correspondence from 29 other states other than our premium tax receipt. I am happy to report that the premium tax collection process is working very, very well. They all have accepted it.

Generally, AFIIC has granted the requests of individual states even though we believed that in many cases the requests were outside the requirements of the Risk Retention Act.

We made a conscious decision that we did not want to become a test case in the legal system for the Act. Because of that decision, we spent a great deal of time, energy, and significant legal expense to achieve our desire to live peaceably in the existing regulatory environment.

In summary, the Risk Retention Act as amended in 1986 is a farsighted and far-reaching piece of legislation. Risk retention groups, if properly capitalized, managed, and administered, can offer the risk manager and the corporate executive the ultimate in risk transfer mechanisms.

Because participants in the risk retention group must own their own insurance company, they will expect their insurance company to offer and enforce an effective loss prevention program.

Because of this legislation, American businesses will make its products and services safer and better than before. The children of the Risk Retention Act, both risk purchasing groups and risk retention groups, are not for the weak of knee or the faint of heart,

but certainly offer the participant the opportunity to control and manage their risks.

I thank you for the opportunity to describe our experience with the Risk Retention Act and ask that the committee give serious consideration to the amendments offered by the Department of Commerce and the Risk Retention Association.

Thank you very much.

[The statement and questions and answers follow:]

STATEMENT OF DAVID A. BOSSMAN, PRESIDENT, AMERICAN FEED INDUSTRY INSURANCE COMPANY, RISK RETENTION GROUP

Mr. Chairman and Members of the Subcommittee

I am David Bossman, President of the American Feed Industry Insurance Company Risk Retention Group (AFIIC). AFIIC was formed as a Risk Retention Group on July 1, 1987 under the 1986 amendments to the Risk Retention Act. AFIIC is a liability insurance company domiciled in the state of Iowa with our principal place of business in Des Moines.

AFIIC insures the product and general liability risks of 56 companies in the livestock feed industry. AFIIC was formed because during the hard insurance markets, including the one in 1985 & 86, many of the traditional commercial insurers dropped coverage on the feed manufacturers. Insurance companies were somewhat unfamiliar with the feed manufacturing as a risk, and when capacity became tight insurance companies frequently would not renew. This left both, small 1 million dollar companies and large billion dollar companies in the feed business either unable to find any product liability coverage, or with the opportunity for coverage at a price which in effect forced them to go bare.

In the midst of the '86 hard market the members of the American Feed Industry Association, the national trade association for feed manufacturers and its suppliers, asked the association to see what could be done to assist them in securing insurance coverage.

Initially, it was assumed that an offshore captive insurance company would be formed for the feed industry.

While in the midst of the feasibility study, the 1986 amendments were made to the Risk Retention Act. We determined that because our members were engaged in similar and related business and their risks were homogenous and because we were seeking to provide liability coverage, we could qualify as a group under the amended Risk Retention Act.

It was our interpretation of the Act that if we formed under the regulatory supervision of one sovereign state, we would need only notify the other 49 states and our filing obligations would be complete. We understood that the state of domicile would have the primary responsibility of regulating the company according to the criteria set forth by its laws and its insurance department regulations.

After performing a domicilary search we determined that Iowa has an extensive insurance industry infrastructure and has a professional and well respected Insurance Department. We decided if we were to be credible with insureds and the insurance regulatory community, we should be licensed in a state noted for its regulatory expertise. Iowa was selected as our domicile of choice even though it does not have a "captive law".

In our formation process we found several provisions of the Risk Retention Act which became burdensome. The most difficult hurdle was the capitalization of the insurance company. Prior to selling insurance a corporation has to be

formed with a myriad of corporate legal documents all costing enough to send several lawyers' first born to the finest Universities of choice. Once the corporate filings were complete the capitalization of the insurance company became a real challenge. We were put in a chicken or egg dilemma. We had to persuade potential insureds to purchase stock in the company before they could buy insurance and before they knew if the insurance company would eventually be authorized to write the coverage.

The Act requires that the owners of a Risk Retention Group be the insureds and the insured be the owners. There are very few reasons why a business would buy stock in its insurance company. If a company believes itself and all other prospective members to be a good risk, it would be willing to invest in its insurance company. Congress in its wisdom facilitated the good risk concept by requiring the insureds to be the owner which would effectively force the companies to implement an effective Loss Prevention program. This requirement for good Loss Prevention, I believe, is what will make Risk Retention Groups succeed in the tough competitive insurance market but it makes formation almost an impossible task. If the Act could be modified to allow a short passage of time before the owner/insured and insured/owner requirement must be met it would allow for initial third party funding which would ease the formation process.

AFIIC was able to leap the chicken or egg hurdle by having trust in its leadership formation team and by condensing the time between the corporate filings and the insurance company authority to 60 days. Believe me it is difficult to call your potential insureds and shareholders and ask that they send by return mail four million dollars and trust me if things don't go right I'll send it back.

The key section of the Risk Retention Act which pursuaded us to forsake the beaches of Bermuda for the cornfields of Iowa was the notification filing provision. Our interpretation of the Act was that we would not have to purchase the services of a fronting company or establish AFIIC as an admitted carrier under each state's separate rules. AFIIC could not exist if we were required to be a licensed company or an approved surplus lines carrier in all the states we wanted to do business. New insurance companies have generally been single state carriers or have gone offshore. We understood that Congress intended, that as a Risk Retention Group we would only have to notify the other 49 states that we are alive and well in Iowa. If the other states wanted more information, they need only call Iowa Commissioner, Bill Hager or his Deputy, Bob Howe to verify that AFIIC was legitimate and that the Iowa Department was going to watch over us.

Well Mr. Chairman, I'm here to report to you that the results on that provision are mixed. After making the notification filing of our Business Plan of Operation which includes everything required in the statute including rates and forms and appointment of the commissioner as agent for service of process, we were confronted with reactions which ranged from a "cease operations or your insureds would lose their licenses for business", to absolutely no response at all, to a host of "send money" requests.

Fourteen states sent applications or registration or filing
forms varying in length and complexity from one page to eight pages. All requests were basically for the same information which was already sent in the Business plan. Each of these states had a filing fee or registration fee or administration fee ranging from $100 to $1,000.

Nine states asked for additional financial information ranging from an annual Audit from Ernst & Whinney before we were a month old, to a copy of our reinsurance contract.

Eleven states asked us to appoint an agent or Surplus Lines Broker in their state even though we did not use an agent because we only market through the efforts of the trade association.

One state has persistently required us to join their joint underwriting and market assistance plans even though we could not use the services.

Soon after our notification filing, two states requested we join their state guarantee fund even though the Act expressly exempts Risk Retention Groups from such plans. We were able to point out to them that we could not participate because we would be in direct violation of the Risk Retention Act.

Three states have lost our filings and asked for another, two states claimed they never received the Business Plan. We have no correspondence from 29 states other than our premium tax receipt.

I am happy to report Mr. Chairman that all 23 states in which AFIIC now does business, have accepted our premium tax payment. While the premium tax rate in some cases is higher for the Risk Retention Groups than for their domestic insurance companies the collection process is working.

Generally AFIIC has granted the requests of individual states even though we believe that in many cases these requests were outside the requirements of the Risk Retention Act. We made a conscious decision that we did not want to become the test case in the legal system for the Act. Because of that decision we have spent a great deal of time, energy and significant legal expense to achieve our desired goal to live peaceably in the existing insurance regulatory environment.

In summary the Risk Retention Act as amended in 1986 is a far sighted and far reaching piece of legislation which will ultimately change the way businesses deal with their insurance needs.

Risk Retention Groups if properly capitalized, managed and administered can offer a risk manager and corporation executive the ultimate in risk transfer mechanism.

Because participants of Risk Retention Groups must have like risks and own their insurance company, they will become more conscious of reducing their own business risks. The owners of the group will expect their Insurance company to offer and enforce Loss Prevention Programs that the Commercial Insurers only dream about and give lip service to. Because of these changes, American business will make its products and services safer, healthier and better than before.

The children of the Risk Retention Act both Purchasing Groups and especially Risk Retention Groups are not for the weak of knee or the faint of heart but certainly offer the participant an opportunity to control and manage their risks which previously were undeniably mired in the bog of the insurance industry's regulatory fog.

AFIIC asks the committee to give serious consideration to the amendments which are offered by the Department of Commerce and the National Risk Retention Association.

Thank you for this opportunity to describe our experience with the Risk Retention Act.

QUESTIONS BY SENATOR BRYAN FOR DAVID BOSSMAN
AMERICAN FEED INDUSTRY INSURANCE COMPANY
RISK RETENTION GROUP

Question:

How many members belong to your Risk Retention Group? In how many states are they located?

Answer:

The American Feed Industry Insurance Company Risk Retention Group currently has 56 companies who are owners and insureds. The companies range in size from 1 million in sales to over 1 billion in sales. Policies are issued in 23 states.

Question:

I understand that you formed one of the earliest Risk Retention Groups after the 1986 ammendments. Please describe some of the difficulties your members were confronting which made formation of this group attractive.

Answer:

During the hard market of the mid 1980's, the feed industry was faced with premium increases in excess of 1,000 percent while forced to drop their coverage by as much as 80 percent. An example: A company purchasing 5 million in coverage for $10,000 were forced to reduce their coverage to 1 million at a cost of $100,000.

Several companies were unable to find a quote at any price and were forced to go bare, i.e., go without any insurance. When the American Feed Industry Association decided to attempt the formation of a Group, the member companies were very supportive. The opportunity to invest in the American Feed Industry Insurance Company would provide them insurance coverage at a stable rate, and their company would understand their business risks.

AFIIC did not promise the prospective insureds the cheapest insurance nor promise that a poor risk would be able to buy coverage. AFIIC's stated purpose was to provide feed industry entities stable insurance rates for companies who would participate in an effective loss prevention program and would be willing to invest their capital in an insurance company for the feed industry.

Question:

Your testimony says that forming groups under the act are not for the "weak of knee or the faint of heart" but offer an opportunity to control risks outside the traditional insurance market. Please expand on that matter.

Answer:

The investors in an insurance company and especially a Risk Retention Group are faced with several risk factors. The initial risk factor is one which I discussed in my testimony regarding the uncertainties of formation. Numerous Risk Retention Groups have been able to form as a corporation but unable to form as an insurance company due to inadequate capital and surplus necessary to receive their certificate of authority from the domicilary state.

The Risk Retention Act requires that the owners be the insureds but does not offer any time frame for a formation process. In order to receive the authority to bind coverage an insurance company must have cash in the bank. It is difficult for companies to go to their management or their bankers asking for several hundred thousand dollars to invest in a future insurance company which may or may not be able to provide insurance.

Another risk factor involved in a Risk Retention Group is the underwriting losses which may be incured. Typically the risks outlined in the feasibility study prepared as a part of the formation process are not the same risks which are actually written. By its very nature, a Risk Retention Group would be formed only by industries or groups which are not adequately and satisfactorily insured by the commercial insurance industry. Therefore the risk of participating in an insurance company which will be writting coverage that a commericial insurer does not want is certainly something which offers a typical financial manager several reasons not to invest.

A Risk Retention Group because it is usually a new company has difficulty attracting quality reinsurance which is necessary to protect the companies assets against large or catastrophic losses.

Finally, the typical commercial insurance industry has been very cyclical in nature and at times is able to offer extremely low premiums to attract new customers. A new insurance company such as a Risk Retention Group is usually unable to participate in that kind of cycle which means it is faced with the possiblity of losing its insureds after a couple of years when the hard market is over.

AFIIC requires the investors to keep their capital in the company for a five year period by not allowing them to withdraw or sell their shares back to the Group.

For these reasons I stated that forming a Group is not for the "weak of knee or the faint of heart", because an investor/insured needs to be aware of all the risks of owning an insurance company and must know that the investment made is a long term commitment and may not pay a dividend for many years.

The opportunity to control risks outside the traditional insurance market come from the strong believe that the Risk Retention philosophy will prompt participants to take a more serious approach to their own Risk management, not only by having higher deductibles or retention levels but also by requiring their Risk Retention Group to implement and enforce effective loss prevention programs for the owner/insured. The traditional insurance industry usually likes to provide first dollar coverage or low deductibles so the premium levels can be increased. The Risk Retention philosophy put forth under the act gives owners and insureds incentives to retain a larger portions of their own risk which gives the impetus to do a better job in their own Risk management.

Question:

You identify some of the specific problems that you confronted with filing notice of intention to do business, including requests for additional financial information requests and agent requirements. States would argue that this information is necessary to protect consumers and ensure the viability of groups. How do you respond to that?

Answer:

Because an insured must be an owner of the Risk Retention Group there is a clear interest on part of the owner/insured to be aware of the financial condition of the company. Since participants are the owners of their companies they are not only well informed of the financial condition but also the entire plan of operation and marketing strategies.

Congress knew that the typical member or participant in a Risk Retention Group would not be an uninformed consumer needing the regulatory protection offered by all 49 individual state insurance departments as well as the domicilary state.

The Risk Retention act does require that one state have the primary regulatory responsibility for the Risk Retention Group. If that individual domicilary state does not offer adequate regulatory oversight and another state has reason to believe it is in a perilous financial condition, it can then request an audit by the domicilary state.

It seems the state insurance departments do not have confidence in the regulatory oversight ability of their peers. Maybe there should be some federal regulation of the various state insurance departments so they have sufficient comfort that their constituents, who are also owners of the insurance company, would be adequately protected.

Question:

Based on your experience, would you recommend to other groups that they utilize the Act? Do the Benefits outweigh the burdens?

Answer:

Yes, I do recommend to other groups that they utilize the Risk Retention Act and form their own Risk Retention Group. At the same time, I do point out the various problems of formation including the costs associated with organizing and capitalizing an insurance company of this type. While it is too early to tell whether the benefits outweigh the burdens over the long term, at this point I would clearly say yes, if you are able to get the authority and put the group together. Obviously the Groups which were unable to complete the process and did not receive the authority prior to the soft market, would say the burdens exceed the benefits.

The opportunities for a Risk Retention Group to be a viable risk transfer mechanism are very real indeed. If the participants use the Risk Retention ideals, the benefits far outweigh the burden's enforced.

Question:

You refer to filing fees required by the states. Do you feel that these fees are imposed as obstacles to formation of groups, or are they required for another purpose?

Answer:

We have noted that some 30 states have accepted our notification filing with no registration forms or filing fees. Generally I would say the fees imposed are not obstacles for

formation of a Group. I believe that in most instances the $100 - $200 fees imposed are simply a standard filing or registration fee which the insurance department requires for all entities.

States which impose obstacles to formation of Risk Retention Groups are doing it in ways other than their filing fee requirements. These obstacles can include the request for additional information or request for information in a format which is not normally prepared as part of the business plan or the feasibility study. These obstacles in my opinion are more aimed at discouraging the formation of a group than the filing fee imposed by certain states.

Senator BRYAN. Thank you very much, Mr. Bossman. We appreciate those comments.

Mr. McIntyre.

STATEMENT OF JAMES T. McINTYRE, COUNSEL TO THE RISK AND INSURANCE MANAGEMENT SOCIETY, INC.

Mr. MCINTYRE. Thank you, Mr. Chairman.

I am here today as counsel to the Risk and Insurance Management Society. RIMS, which I will refer to as the Risk and Insurance Management Society, an acronym, commends the committee for holding these oversight hearings on the Risk Retention Act.

RIMS is a trade association representing more than 4200 corporate, governmental, and nonprofit consumers of insurance in over 80 chapters throughout the United States and Canada. Its 7500 deputy members are employed as risk and employee benefit managers for entities as diverse as the Girl Scouts of America, General Motors, the City of Virginia Beach, and the Archdiocese of Baltimore. Collectively, its members purchase billions of dollars of insurance and insurance services each year.

The importance of the Risk Retention Act is not that it has created any novel insurance concepts, but rather that it democratizes the process so that alternative methods of securing insurance coverage are available to small as well as large insurance policyholders.

For instance, while setting up a group captive is a formidable task in itself, Federal and state security registration requirements and, perhaps more significant, obtaining licenses from all 50 states and setting up compliance programs for each have created significant startup costs which often rule out the group captive option for smaller policyholders.

Indeed, many larger policyholders choose overseas situses not for their exotic locale or tax considerations, but rather because of the significant added time and expense required to form and operate a group captive on a multistate basis in this country.

Similarly, it is generally only the larger commercial policyholders who are on a group basis in this country.

RIMS urges the subcommittee not to be lulled into inertia by a temporarily soft insurance marketplace. Prompt legislative action must be taken to implement most of the Department of Commerce's recommendations so that the explosive growth of the alternative market sector can be accommodated under existing state insurance regulation through the Risk Retention Act mechanism.

Give the insurance consumer a viable alternative mechanism before the next hard market cycle arrives.

Although modifications are needed to the Risk Retention Act group provisions of the Act, many of the actual regulatory problems are focused on the purchasing group aspect of the legislation.

RIMS believes that the policy debate over the Risk Retention Act was settled by Congress in 1981 and reaffirmed in 1986. Rather than rehashing old arguments, it is now time to concentrate on making the Act workable so that its intent can be fulfilled.

Unfortunately, ambiguities in the Act are limiting the benefit of the purchasing group provisions to insurance commissioners. RIMS

is firmly convinced that consumerist modifications can be made to the legislation modeled on the Department of Commerce's recommendations which will be fully compatible with viable state regulation.

As a strong supporter of state regulation, RIMS believes that a fully operational Risk Retention Act is needed to bring the state regulation of insurance into the twentieth century. RIMS is most sympathetic to legitimate regulatory concerns that solvency provisions in the Act should be strengthened, particularly in the purchasing group area.

Indeed, one of the reasons that we support modifications to the Act is to weed out those bad players, be they risk retention groups or purchasing group insurers, who will not be able to meet their promise of insurance protection when liability losses occur in the future.

RIMS is supportive of the Department of Commerce recommendations which would establish minimum financial standards to qualify as a purchasing group insurer, require additional information to be filed with state regulators by purchasing group insurers, and provide additional consumer safeguards for potential purchasing group policyholders.

However, when one reviews the basic problems surrounding the implementation of the Risk Retention Act, one discovers that the real regulatory concern is the state insurance commissioners' reluctance to give full faith and credit to the judgment of a fellow state regulator. State regulation of insurance all too often operates as if the United States were still under the Articles of Confederation, with little or no comity being given to the regulatory judgment of sister states.

RIMS is not challenging the ability of a state regulator to shut down the operations of a purchasing group insurer or risk retention group when he or she has legitimate solvency concerns. In fact, under the Act any single state regulator can shut down the operations of a risk retention group nationwide by obtaining an injunction in Federal court, an option which regulators do not have with a traditional insurer.

RIMS would be most willing to work toward developing a compromise where a similar power to enjoin could be used to suspend insurance companies from underwriting purchasing groups.

However, many of the problems created—cited by the Department of Commerce involve the fulfillment of the central thrust of the Risk Retention Act, that is to allow multistate insurance consumers and insurers to develop national insurance programs involving either the creation of alternative market facilities or the group purchase of insurance.

To use an example, suppose the American Bar Association wishes to institute a national program of professional liability coverage for its members under the aegis of a purchasing group formed in the state of its incorporation, Illinois.

Assume the Illinois director of insurance approves the purchasing group insurer's rates, forms, and mode of operation. Must the purchasing group insurer obtain form and rate approval in the other 49 states where policyholders are likely to be located?

Can a truly uniform national program be developed under such circumstances? Suppose the purchasing group insurer is licensed in only 40 states? Must coverage be placed through the surplus lines mechanism in the remaining jurisdictions, where state law often allows admitted insurers to veto such a transaction by offering to accept the risk, even if it means a higher premium and less attractive coverage for the insured?

Before the American Bar Association can send out notice to its members advising them of this national insurance program, must it obtain insurance agents' licenses in all 50 states?

If the answer posed by these questions is yes, then the benefits provided to the insurance consumer under the Act are little more than an empty promise.

Mr. Chairman, we have included with our testimony a booklet that we would ask to be committed to the record, and we would also ask that additional time be given so that we can file our specific comments on recommendations for amendments to the Act.

Senator BRYAN. That will be incorporated by reference and we appreciate your testimony, Mr. McIntyre.

[The statement and questions and answers follow:]

STATEMENT OF JAMES T. MCINTYRE, COUNSEL, RISK AND INSURANCE MANAGEMENT SOCIETY, INC. (RIMS)

The Risk and Insurance Management Society, Inc. (RIMS) commends the Consumer Subcommittee for holding this much needed oversight hearing on the Risk Retention Act (hereinafter referred to as the Act). RIMS is a trade association representing more than 4,200 corporate, governmental, and nonprofit consumers of insurance in over 80 chapters throughout the United States and Canada. Our 7,500 deputy members are employed as risk and employee benefit managers for entities as diverse as the Girl Scouts of America, General Motors, the City of Virginia Beach, and the Archdiocese of Baltimore. Collectively, our members purchase billions of dollars of insurance and insurance services a year.

Despite the controversy surrounding the Act's passage in 1981 and the amendments to the Act in 1986, the changes rendered by the legislation are relatively modest. Under the Act, a group of similarly situated policyholders can set up an insurance facility, called a risk retention group, by conforming to the requirements imposed by the state where the risk retention group is chartered. The risk retention group receives limited preemption to operate in other states and is exempt from federal securities and state "blue sky" registration requirements. Purchasers of insurance with similar liability exposures are permitted to band together through entities called risk purchasing groups, for the purpose of securing insurance coverage on favorable terms and conditions by purchasing insurance on a collective basis.

In principle, there is nothing revolutionary about any of these concepts. Factory mutuals, started by business persons disgruntled at their treatment by the traditional insurance industry in the 1800's, are the forerunners of risk retention groups. These factory mutuals are a significant part of the traditional market today. Within the risk management community, so called "group captives," direct predecessors to risk retention groups, have been around for decades. So called "safety groups," similar to risk purchasing groups created under the Act, have been underwritten on a limited basis by the traditional insurance industry since the 1950's.

The importance of the Act is not that it has created any novel insurance concepts but rather that it democratizes the process so that alternative methods of securing insurance coverage are available to small as well as large insurance policyholders. For instance, while setting up a group captive is a formidable task in itself, federal and state security registration requirements and perhaps more significant, obtaining licences from all 50 states and setting up compliance programs for each, have created significant start-up costs which often rule out the group captive option for smaller policyholders. Indeed, many larger policyholders choose overseas situses not for their exotic locale or tax considerations, but rather because of the significant added time and expense required to form and operate a group captive on a multi-state basis in this country. Similarly, it is generally only larger commercial policyholders

who are underwritten on a group basis in this country. So-called state fictitious group laws (New York is fairly typical in that its state statute generally prohibits liability insurance coverage from being written on a group basis) and statutes permitting each state to mandate and/or review policy forms and rates often preclude insurers from offering a national uniform program for multi-state policyholders with similar risks.

Development of a viable risk retention mechanism is vital to the insurance consumer in several major respects. Properly operated risk retention groups can serve to significantly insulate their policyholders/owners from the insurance availability/affordability problems associated with the violent swings of insurance market cycles. While commercial insurance consumers currently have the luxury of being in a "softening" (buyer oriented) insurance marketplace, most risk managers are cautiously planning for the "hard" (seller oriented) market cycle that surely looms ahead.

While risk managers hope never to see the return of the insurance availability/affordability crisis of 1984-1985, RIMS perceives few if any operational changes in the insurance industry which would lead us to conclude that future market cycles will be moderated. At a recent symposium, the president and C.E.O. of Arthur J. Gallgher and Company, a major insurance broker, noted that the alternative market is growing twice as fast as the traditional sector, with most experts predicting that when the next hard market arrives, the alternative sector will insure well over 40 percent of the market. The current

growth of the alternative sector has been taking place mostly outside the ambit of the Risk Retention Act, largely because of ambiguities contained in the Act which were ably highlighted and addressed by the U.S. Department of Commerce in its legislative implementation report.

RIMS urges this subcommittee not to be lulled into inertia by a temporarily soft insurance marketplace. Prompt legislative action must be taken to implement most of the Department of Commerce's recommendations so that the explosive growth of the alternative market sector can be accommodated under existing state insurance regulation, through the Risk Retention Act mechanism. Give the insurance consumer a viable alternative mechanism before the next hard market cycle arrives.

Although modifications are needed to the risk retention group provisions of the Act, many of the actual regulatory problems are focused on the purchasing group aspect of the legislation. The purchasing group provisions of the Act permit the collective purchase of insurance by the vast number of insurance consumers who can and should be served by the traditional insurance marketplace. From a consumer perspective, the purchasing group concept may increase his or her "clout" in the marketplace, by allowing the policyholder to secure more favorable coverage and terms than if the insured attempted to secure such coverage individually. From an insurer's

prospective a purchasing group may be attractive to underwrite because:

a) It may be better able to enforce risk management and loss prevention standards on a group basis than on an individual insured basis (the safety group concept);

b) The actual losses of a large number of insureds should more closely reflect anticipated actuarial loss projections than that of a single policyholder; and

c) Cost savings can be realized by providing a large group of insureds uniform coverage under uniform rating standards.

RIMS believes that the policy debate over the Risk Retention Act was settled by Congress in 1981 and reaffirmed in 1986. Rather than rehashing old arguments, it is now time to concentrate on making the Act workable so that its intent can be fulfilled. Unfortunately, ambiguities in the Act are limiting the benefit of the purchasing group provisions to insurance consumers.

RIMS is firmly convinced that consumerist modifications can be made to the legislation, modeled on the Department of Commerce's recommendations, which will be fully compatible with viable state

regulation. As a strong supporter of state regulation, we believe that a fully operational Risk Retention Act is needed to bring the state regulation of insurance into the 20th century. RIMS is most sympathetic to legitimate regulatory concerns that solvency provisions in the Act should be stengthened, particularly in the purchasing group area. Indeed one of the reasons that we support modifications to the Act is to weed out those bad players, be they risk retention groups or purchasing group insurers, who will not be able to meet their promise of insurance protection when liability losses occur in the future. RIMS is supportive of Department of Commerce recommendations which would establish minimum financial standards to qualify as a purchasing group insurer, require additional information to be filed with state regulators by purchasing group insurers, and provide additional consumer safeguards for potential purchasing group policyholders.

However, when one reviews the basic problems surrounding the implementation of the Risk Retention Act, one discovers that the real regulatory concern is the commissioners' reluctance to give full faith and credit to the judgement of a fellow state regulator. State regulation of insurance all too often operates as if the United States were still under the Articles of Confederaton, with little or no comity being given to the regulatory judgement of sister states. RIMS is not challenging the ability of a state regulator to shut down the operations of a purchasing group insurer or risk retention group

when he or she has legitimate solvency concerns. In fact, under the Act, any single state regulator can shut down the operations of a risk retention group nationwide by obtaining an injunction in federal court, an option which regulators do not have with a traditional insurer. RIMS would be most willing to work toward developing a compromise where a similar power to enjoin could be used to suspend insurance companies from underwriting purchasing groups.

However, many of the problems cited by the Department of Commerce involve the fulfillment of the central thrust of the Risk Retention Act - to allow multi-state insurance consumers and insurers to develop national insurance programs involving either the creation of alternative market facilities or the group purchase of insurance. To use an example, suppose the American Bar Association wishes to institute a national program of professional liability coverage for its members under the aegis of a purchasing group formed in the state of its incorporation, Illinois. Assume the Illinois Director of Insurance approves the purchasing group insurer's rates, form, and mode of operation. Must the purchasing group insurer obtain form and rate approval in the other 49 states where policyholders are likely to be located? Can a truly uniform national program be developed under such circumstances? Suppose the purchasing group insurer is licensed in only 40 states. Must coverage be placed through the surplus lines mechanism in the remaining jurisdictions, where state law often allows admitted insurers to veto such a transaction by

offering to accept the risk, even if it means a higher premium and less attractive coverage for the insured? Before the American Bar Association can send out notice to its members advising them of this national insurance program, must it obtain insurance agent licences in all 50 states? If the answer posed by these questions is "yes," then the benefits provided to the insurance consumer under the Act are little more than an empty promise.

Similarly, while the current problems encountered by risk retention groups under the Act are less severe, modifications to the legislation are needed before these entities can develop into viable group captive facilities.

RIMS requests that the record of this hearing be kept open so that we may submit a more detailed proposal on amendments to the Risk Retention Act. For the purposes of this hearing, we have attached a copy of our 1988 paper outlining problems with the Act's implementation and RIMS' recommended solutions. Our comments are organized around the Department of Commerce report.

However, given the general nature of this oversight hearing, the central thrust of our testimony today is to reiterate our support of the Act, emphasize the importance of prompt congressional action to enact amendments which will ensure that the legislation's consumer benefits will be realized, and to offer our cooperation to this

subcommittee and the regulatory community in achieving such amendments. Toward this end, RIMS believes it is absolutely vital that the National Association of Insurance Commissioners, as a representative of the collective state regulatory community play a more active and constructive role in developing modifications to the Act.

With such cooperation, the long term interest of the consumer - insurance availability, affordability, and solvency - can be enhanced through the risk retention mechanism.

Thank you.

QUESTIONS OF SENATOR BRYAN AND THE ANSWERS

Q: You refer to the fact that the Alternative Insurance Marketplace is growing twice as fast as the alternative sector, but that the risk retention act has generated only a small part of this growth. You also urge Congress to amend the act in anticipation of a hard insurance market, so that coverage will be available for people under the act when insurance becomes unaffordable and unavailable.

-- When do you anticipate that these affordability/availability problems will again manifest themselves?

-- Do you anticipate that the next hard cycle will be as severe as the last?

A: Predicting insurance cycles is a difficult task. These cycles are driven by:

1. Interest rates
2. Inflation
3. Taxation
4. The overall U.S. business cycle
5. The value of the dollar relative to other major currencies
6. The U.S. Stock Market
7. Competition for market share

The bottom line for the commercial insurance consumer is that the premium which the policyholder pays is often a function of what the marketplace will bear rather an accurate underwriting analysis of the risk which the insurer is being asked to accept. Underwriting decisions are often inextricably entwined with the insurance market which is in turn driven by conditions which are in themselves highly unstable. One thing is certain however; insurance cycles do occur and there will be another hard market.

At present we are in the early stages of a soft market cycle for most lines of insurance. Informed estimates of how long this soft market cycle will last range from the beginning of 1991 to sometime in 1993. The length of the soft market cycle and the extent to which unrestrained rate cutting occurs will in turn determine how severe the insurance availability/affordability crisis will be when the hard market begins. One major difference between this soft market and the early 1980's is the greater retention of risk by insurance carriers today. In other words, insurance companies are reinsuring far less than they did a decade ago.

What this means is that in the early 1980's, the insurers were slashing rates, to a significant extent, with reinsurers' money. If present trends continue, and reinsurer participation is limited, a far greater percentage of the insurance companies' own capacity will be on the line if predictable rate cutting during the soft market occurs. Thus while RIMS does not wish to be the prophet of doom, we see few favorable indications that would assuage our concerns that the next hard market, whenever it occurs, will spawn an insurance availability/affordability crisis as severe as the one encountered from 1984-1986.

QUESTION #2

Q: You suggest that the real problem with the Act is the failure of state insurance commissioners to give deference to the judgment of other commissioners.

-- How should this be solved? If Congress were to make every clarifying amendment suggested, would this problem not make its efforts somewhat hollow?
-- The insurance commissioner would likely respond that they are obligated to maintain vigilance on behalf of the citizens of their states. How could more national uniformity in interpretation be achieved?

A: RIMS understands the reluctance of this Subcommittee to dictate on an overly specified basis how a state insurance commissioner can or should regulate risk retention/purchasing groups created under the Act. Similarly, we have always recognized the legitimate need of an individual state regulator to take unilateral action to protect the interests of the policyholders in his or her state.

In our opinion, the passage of the Risk Retention Act in 1981 and the amendments in 1986 were mandates by Congress to state regulators to isolate those areas of crucial regulatory concerns where unilateral authority is required, while coordinating through the limited deference of authority to the group's domicillary jurisdiction other aspects of insurance regulation.

To illustrate how the dual concerns of uniformity and consumer protection can be accommodated, one can look at the crucial regulatory responsibility of solvency monitoring. Under the Department of Commerce (DOC) recommendation, the purchasing group's domicillary state regulator would have the responsibility of overseeing whether the insurer was properly capitalized and rates were adequate. To address regulators' concerns that purchasing groups may gravitate to states with weak regulation, the DOC has recommended that minimum operation and capitalization requirements be met by the purchasing group insurer before it can provide coverage under the Act. To provide nondomicillary states with adequate information to judge a purchasing group's solvency and soundness of operation, the DOC has recommended that additional information on the group's management and insurer be contained in the notice which the group gives to every regulator of the jurisdictions in which it operates.

Under RIMS' proposal, each regulator would have the unilateral ability to enjoin a carrier which he or she fears is in hazardous financial condition from serving as a purchasing group insurer by obtaining an injunction in either federal or state court. An injunction obtained in the former venue would operate not only in that state, but nationwide.

If further safeguards can be built into the Act to address regulators' legitimate solvency concerns, RIMS would be most anxious to explore them. Unfortunately, short of insisting that state by state rate regulation is the only alternative, the National Association of Insurance Commissioners (NAIC) has not commented on these safeguards, or offered any viable counterproposals.

This illustration is indicative of how legitimate concerns of all parties could be accommodated if only the NAIC, as a representative of the collective regulatory community, could be moved to engage in meaningful discussions as to needed amendments to the Risk Retention Act. RIMS' suggestions are meant to give regulators significant power to safeguard the public interest while clarifying the ambiguities which have made comity so problematic.

QUESTION #3

Q: Your testimony addresses a number of problem areas in implementation of the Act.

-- Are legislative amendments necessary to clarify these points? Wouldn't a different, more receptive approach by state insurance regulators obviate the need for legislative fixes? If not, in what areas would legislation still be needed?

A: While certain problems can be addressed by having a risk retention/purchasing group work with individual state regulators on an ad hoc basis, ultimately no degree of the uniformity needed by multi-state groups to operate on a long term basis will be achieved in this fashion. Similarly, while RIMS and other affected groups and organizations have worked with the National Association of Insurance of Commissioners (NAIC) in the promulgation of an NAIC model Risk Retention Act implementation law, this approach also has its limitations.

First, the uniform implementation of NAIC model legislation is, to say the least, uneven. Secondly, the tendency of the NAIC is to accommodate the comparatively few regulators who wish to preserve the maximum degree of state regulatory autonomy, even if it means a model law which either violates the federal Act, or strains its meaning or intent.

By way of historic background, when the Risk Retention Act was passed in 1981, the NAIC promulgated model implementing legislation.

The Act, which permitted risk retention/purchasing groups to offer product liability coverage, contained a clear definition of "product liability." Despite this clarity, the NAIC promulgated a model law which purported to preserve the right of each state to define "product liability." Clarifying technical amendments by Congress were required to thwart this misinterpretation.

RIMS' point in offering this background is not to dismiss the participation of the NAIC or state regulators in this legislative process. Indeed, RIMS has continually urged the NAIC to work with interested groups in developing amendments to the Act which will make the legislation a more viable tool for both regulators and consumers. But this history of state regulators' approach to the Act indicates that the uniformity required to make the Act workable will only be achieved by further legislative guidance.

With regard to where legislative guidance is needed, the recommendations offered by the National Risk Retention Association and the Department of Commerce to your Subcommittee would be an excellent foundation from which to consider future amendments to the Act.

QUESTION #4

Q: The Risk Retention Act was established to create alternatives to the traditional insurance market. You testified that it has succeeded, to some extent at least, in this regard. Specifically, in what ways does RIMS feel that the Act has had the most impact on the insurance marketplace?

A: Given the strong growth of the alternative market in general, the number of risk retention/purchasing groups formed under the Act is relatively modest, as is the volume of coverage written by and for these entities. This is hardly surprising, considering both the soft market and the potential for regulatory roadblocks and litigation these entities face in their operations.

Nevertheless, according to the Risk Retention Reporter of April 15, 1989, the combined total of risk retention and purchasing groups tops 400. The 348 purchasing groups had an estimated 1988 premium of $97.3 million; risk retention groups had an estimated 1988 premium of $269.9 million with an estimated 11,000 policyholders.

However, these dry statistics tell only a small part of the story as to the impact that the Act and the alternative market have had on the traditional insurance market. One impact which cannot be quantified is the extent to which these facilities have prompted competition in the marketplace, and served as a catalyst in ending the insurance availability/affordability crisis of 1984 - 1986. RIMS has received

numerous anecdotal reports of how insurance premiums decreased and coverages improved in the traditional market when alternative facilities (such as for Bankers' Directors and Officers coverage) were being formed. We have high hopes that the existence of such alternative facilities will help moderate future cycles. Given the time, effort, and expense it takes to establish such facilities, many policyholders are not inclined to return fully to the traditional market even when the cycle softens. The existence of the alternative market sends a powerful message to the insurance community -- policyholders do not wish to remain vulnerable to the vagaries of boom/bust market cycles.

However, it would be far too simplistic to assume that the development of these alternative facilities is a zero sum gain where the progress of captives, risk retention groups, and similar mechanisms is won at the expense of the traditional market. There has been a growing accommodation and even encouragement toward alternative markets from many sectors of the traditional insurance market - including primary carriers, producers, and reinsurers.

For primary carriers and reinsurers, participation in these alternative facilities may lessen their own vulnerability to market cycles. Almost all these facilities require reinsurance and excess loss protection, as well as ancillary services such as claims support, underwriting management, and loss control. Under traditional market relationships, both buyer and seller often try to squeeze the hard and soft cycles to their own advantage, often to their long term mutual disadvantage. In a properly structured relationship involving a carrier and an alternative facility, there can exist a common stake in

each other's future. As pointed out by a British risk manager,there must be a redefinition of acceptable self interest between buyer and seller which includes profits for the carrier and stability for the policyholder. One might question why the interjection of an alternative facility between policyholder and carrier would assuage the friction between the two parties. As stated earlier, policyholders capitalizing alternative facilities are seeking stability, not a short term means to ride out the hard market. These policyholders have a very real financial stake in the success of the facility; sound underwriting, not market share, becomes of paramount importance. Thus the relationship between the carrier/reinsurer and the facility becomes more of a joint venture than an insurance contract's transfer of risk.

Insurers and reinsurers who have formed subsidiaries or units to service these facilities include Gen Re (Geneisis), AIG (AIG Captive Management), Continental Insurance (Continental Retention and Speciality Managers), Aetna Life and Casualty (Axia Services), and American Re.

Purchasing groups can also be expected to have an even greater impact on the traditional insurance marketplace once regulatory uncertainties can be addressed and both insurers and policyholders can plan their programs with greater certainty. As pointed out by the National Risk Retention Group Association, many of these groups have provided their members with more favorable prices and more attractive policy conditions than are available in commercial markets, as well as the expectation that these ventures will stay in the market during the

next insurance crisis. Even in those cases where puchasing group insurers have established programs for otherwise unavailable coverages at higher than soft market rates, they have helped to fill gaps in the commercial marketplace that were not filled by traditional non-group insurance products.

QUESTION #5

Q: You support strengthening solvency provisions in the Act, in part to weed out bad actors who will not be able to meet their obligations when liability losses come due.

-- Do you know of situations where that has existed to date, or are you merely anticipating the possibility of such an occurrence?

A: According to Risk Retention Reporter, only 42 percent of purchasing group insurers are rated by the 1987 A.M. Best's Key Rating Guide. While not being rated in Best's is not necessarily indicative of instability, RIMS had hoped that it would be primarily the larger, more well known insurance carriers who would serve the market as purchasing group insurers.

As a precaution against unsuitable carriers serving as purchasing group insurers, RIMS supports the Department of Commerce's recommendation to amend the Act so as to require minimum capitalization and operational standards in order to qualify as a purchasing group insurer. In addition, RIMS proposes that each state regulator be given the unilateral authority to seek a court injunction against a purchasing group insurer which he or she fears is in hazardous financial condition.

A more troubling question is why more major insurers are not serving as carriers for purchasing groups. RIMS would suggest that these large insurers have the most to lose and fear the retribution of in-

surar regulators hostile to the Act. Given the ambiguities contained in the Act, such fear is justified. For instance, within the last few months, two large reputable insurers, Home and Transamerica, were given six figure fines by the New York Insurance Department for not submitting for prior approval rates and forms they provided to purchasing groups with New York policyholders. It seems to be the unfortunate case that it is the larger carrier that makes the most inviting and easiest target for regulatory sanctions. Therefore, greater uniformity and clarity is needed in the Act so that the larger, well capitalized insurers will be given the confidence required to establish purchasing group programs.

RIMS' concerns may already be reality. While not knowing the facts of these cases to characterize them as "bad actors," it seems that three potentially undercapitalized insurers - Victoria Insurance Company LTD, Bel-Aire Insurance Company, and New England International Surety of America (NEISA) - were serving as purchasing group insurers. Prompt action by insurance regulators appears to have addressed these problems without any loss to policyholders [Enclosed are articles from the Risk Retention Reporter on these purchasing group insurers]. In short, the regulatory system seems to have responded as it can and should under the Act with regard to solvency.

With the added safeguards proposed by the Department of Commerce and RIMS, consumer protection would be further enhanced.

QUESTION #6

Q: If an agent organizes a purchasing group, can that group obtain the best insurance arrangement possible, or is there a conflict inherent in that relationship? In other words, should there be a prohibition on agents forming such groups?

A: The inherent conflict referred to exists in all agent/policyholder relationships, not just within the Risk Retention Act. By definition, an agent is one who solicits, negotiates, or sells insurance policies on behalf of one or more insurers; thus there are numerous potential instances where the interests of the agent and policyholder diverge. For instance, an agent may benefit when premiums are high (assuming coverage is available) because his or her remuneration is often based on commission. Similarly, an independent agent must often face the temptation of looking at what one insurer pays in commission as opposed to another in determining which insurer he or she should recommend to a client.

Despite the inherent conflicts which do exist in the agency system, an insurance agent who is doing his or her job can offer a value added service to earn that commission.

Such services include:

a. Searching the marketplace for the best available coverage
b. Advising the client as to his or her insurance needs
c. Acting as an ombudsman for the policyholder in the settlement of claims.

Therefore, whether in the context of the Risk Retention Act or an ordinary insurance transaction, the use of an agent can be counterproductive or invaluable depending upon what services the agent brings to the table.

In the case of purchasing groups, it is important to recognize that these entities do not form out of thin air. It is an extremely rare situation when a widget manufacturer, seeing an insurance problem, will say "Let me get my competitors in one room and start a purchasing group so that we may all purchase insurance collectively". In reality, a substantial amount of work needs to be done including:

1. Locating and contacting similarly situated potential policyholders
2. Evaluating whether the potential group's coverage problems can be addressed by a collective solution
3. Negotiating appropriate coverage and premium for the group with the insurer.

In most situations, a single policyholder will have neither the expertise nor inclination to devote a significant amount of hours, expense, or effort to the task. Possibly the Widget Manufacturers Trade Association can fill this void, but in many instances such an entity does not exist or may decline, for valid reasons, to get involved.

Depending upon the circumstances, an agent can be an important catalyst in getting such a purchasing group off the ground. He or she has a book of business (or access to other agents who do) which represents the collective number of policyholders needed to "sell" an in-

surer on the group concept. He or she can knowledgeably search the marketplace for an appropriate insurer. Similarly, such an agent can advise the purchasing group members as to their coverage needs, and negotiate a fair deal with an insurer.

Clearly, the inherent conflict of interest about which you inquire does not disappear in the purchasing group concept. Ideally, RIMS would hope that an agent forming such groups would operate on either a reduced commission/fee for services basis (if state anti-rebating laws do not preclude such an arrangement). While RIMS acknowledges that the potential for abuse may exist, we urge you not to underestimate the force of the marketplace. Just as the agent who pads his or her commission or does not offer a value added service to the insurance transaction will quickly lose clients, so will an agent who so abuses his or her relationship with a purchasing group.

In short, while RIMS strongly opposes a requirement that an agent must be used in all purchasing group transactions, we also recognize that precluding agent involvement may vitiate the possibility that purchasing groups will be formed.

Senator BRYAN. Mr. Laborde, did I pronounce your name correctly?

STATEMENT OF LUCIEN P. LABORDE, JR., ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS

Mr. LABORDE. Yes, you did, sir. Thank you.

Mr. Chairman, I am sincerely appreciative and excited to have the opportunity to be here today testifying on behalf of the National Association of Insurance Brokers. Brokers play an important role as an intermediary between the insurance buyers and commercial insurance marketplace.

The Liability Risk Retention Act of 1986 is needed as an alternative risk financing mechanism. The law is functioning much as Congress has intended. This is evidenced by the fact that risk retention groups and purchasing groups, as our panelists have indicated, are being formed.

Our major concerns also are associated with the area of the risk purchasing groups, where we feel that there are distinct differences that are critical. In the risk retention group process, you require both a capital contribution and premium payment, and there is substantial information through the feasibility process that is distributed to the members. Many attempted startups of risk retention groups have failed as a result of the information and feasibility process.

The purchasing group process is similar to an insured purchasing coverage from the traditional marketplace, and there is a clear profit incentive on behalf of the insurance carrier in this case. As a result, we believe that there is a critical distinction between the two groups, and greater consumer protection is warranted for purchasing groups.

The NAIB supports specific minimum financial solvency standards for risk purchasing group insurers. We propose three standards for consideration: first, a three to one net written premium to capital and surplus ratio; second, a ten to one minimum capital and surplus to net per occurrence retention ratio; and, third, a $3 million absolute minimum on capital and surplus.

As a second critical issue, we see the issue of policy form and rate regulation of risk purchasing groups by states. The U.S. district court in Iowa, as indicated, has held that purchasing groups are located in each state where there is an insured. This contradicts, we believe, the Congressional intent of the law and defeats the purpose of the law. Only the state of domicile should have the ability to review the policy rate and forms.

However, there is a distinction. Rate and form regulation is not the same as the ability to regulate to a financially impaired group, which, through the court process, is available to all states.

We think in all fairness and equity that there are a couple of related issues that should be decided in favor of the states. First, it should be clear that the guarantee funds, just as for risk retention groups, should not be available for purchasing groups. We think it would be inequitable to limit state regulation of rate and policy form coverage, and then tap state guaranty funds when rates are

too low and groups become insolvent. This is not explicit within the current Act.

We also believe that from a taxation standpoint, the surplus lines tax rate should be applicable to risk retention and purchasing groups. They operate and are regulated on much the same basis as surplus lines insurers. Some proposals which we have seen have asked that the admitted carrier tax, or preferred tax status, be applied to the risk retention and purchasing groups.

The definition of the location of a purchasing group is key, and we think that the group should have the right to select the domicile or the state in which it is physically headquartered.

Getting on to some different issues that apply to both risk retention groups and purchasing groups, we would like to see some very limited expansions of coverage to offset some of the compatibility problems in the current market. For example, physical damage coverage is typically provided in commercial automobile liability insurance but because this is a property form, it is not permissible under the Act. This severely restricts the ability to effectively provide commercial coverage for automobiles under the Act by not having it.

As a similar example, umbrella coverage typically includes excess employer's liability (not primary). We would like to see an amendment whereby excess employer's liability could be provided so that standard umbrella liability coverage would fall within the scope of the Act.

We think that the exemptions from the security laws should be made more clear. Specifically, the organizers of risk retention groups should not be required to be licensed as registered security dealers.

On the issue of state filing fees, we believe that only the state of domicile should have the authority to assess filing fees. We want to remind the state insurance commissioners that we are also supporting surplus lines taxes payable on the premiums. These taxes will support regulatory review of the groups.

We also believe that information forms should be required and standardized for both purchasing groups and risk retention groups. The Department of Commerce should develop a standard form if the NAIC does not.

Finally, we would like to see a provision in the law that gives the Federal government the authority to enjoin state action where that action unreasonably discriminates against risk retention group or risk purchasing group formation.

We plan to provide additional specific recommendations to the Department of Commerce. We again appreciate the opportunity to be here today and look forward to your questions.

[The statement and questions and answers follow:]

STATEMENT OF LUCIEN P. LABORDE, JR., ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS

Good afternoon. Thank you for the opportunity to testify today. My name is Luke Laborde, and I am president and chief executive officer of research and development for Corroon & Black, one of the nation's largest commercial property-casualty insurance brokerage firms.

I am testifying today on behalf of the National Association of Insurance Brokers, and I serve on the association's Risk Retention Task Force. NAIB is the trade association of commercial insurance brokers. Its members, who range in size from large international companies to regional and local firms, provide insurance and risk management services to clients in the United States and around the world. NAIB members administer the majority of all commercial insurance in the United States.

Brokers play a critical role in the insurance business by representing their clients in the insurance marketplace, organizing new insurance capacity and helping design alternatives to traditional insurance coverage. Clients of NAIB member firms operate in every state of the union and internationally. They range from multinational corporations to small businesses and individual policyholders. They also include nonprofit organizations and government entities.

NAIB members believe the 1986 Liability Risk Retention Act provides an important self-insurance alternative that helps insurance buyers meet their risk financing needs. The need for this option can be critical when insurance coverage is either unavailable or unaffordable in the traditional marketplace. We also believe the existence of this option encourages the traditional marketplace to be more responsive to buyers' needs. In addition, the 1986 law provides third parties, who may suffer injury as a result of the actions of the insured, with a measure of protection that would be unavailable if no insurance coverage were in place.

However, the existence of this option does not solve all market capacity problems. Even when properly structured, groups are not easy to form, capital is hard to raise, and premiums are not necessarily lower than conventional market prices.

The extent to which the risk retention and purchasing group mechanisms are used tends to hinge on the insurance cycle. Today, with the soft market and liability coverage more readily available and affordable, insurance buyers are less likely to pursue these alternatives. However, obtaining coverage for some high risk products, environmental impairment and professional liability can still be difficult today, and they are likely to pose tougher problems in the future when the cycle turns and

there are availability and affordability problems for all types of insurance coverage.

The question before us today is, "How well is the law working?" NAIB believes it functions today much as Congress intended because both risk retention and purchasing groups are forming. There are some problems, however. Most of our concerns center on financial solvency.

First, some background. The law provides strong regulatory measures for auditing the financial condition of risk retention groups and includes injunctive authority that regulators can seek through the courts if they believe a group is violating the law. The focus of this regulatory power is the group's state of domicile. By meeting the regulatory requirements of the state of domicile, risk retention groups can operate across state borders, though they must provide regulators in all states where the group has members with copies of financial statements and other documents that are key to regulatory scrutiny.

The most troubling aspect seems to be regulation of risk purchasing group insurers and concern that the law is being used to evade legitimate and necessary state regulation of underwriters. There seems to be less concern with risk retention groups, due, we believe, to the different nature of a such groups. Establishing a risk retention group is not easy, because

4

capital contributions are needed in addition to premium payments. By the time a group is formed, its member insureds should have a pretty good idea of their risk exposure and the reliability of the group as an insurer. Buyers have a great deal of information to help them assess this risk financing option.

In contrast, insureds approach a risk purchasing group much like they would approach an insurer in the traditional marketplace. The law facilitates setting up a group insurance program, with policyholders of the group transferring their risk exposure to an underwriter rather than seeing themselves in the dual role of policyholder and insurance company owner as when they participate in a risk retention group. This distinction is critical, and the level of consumer protection that is warranted for a risk purchasing group is greater.

A recent survey by the "Risk Retention Reporter" indicates a significant number -- 340 -- purchasing groups have been formed and are active. Survey data for three types of purchasing group coverage -- medical/dental and related services, environmental impairment, and professional services -- revealed that 80 percent are active. They cover 200,000 insureds and generated an estimated $280 million in premium in 1988.

Though we cannot document examples of financially impaired risk purchasing group insurers operating today, we are

sympathetic to regulators' concerns in this instance. The NAIB supports amending the law to include minimum financial solvency standards for risk purchasing group insurers.

There are numerous financial standards that could be applied. We support the following three: a 3:1 net written premium to capital and surplus ratio; a 10:1 minimum capital and surplus to net per occurrence for claim retention ratio; and a $3 million absolute minimum on capital and surplus. Together, these standards should provide a reasonable level of assurance that the insurer is financially stable.

Since the law was enacted, other problems have surfaced, and I will give you a brief summary of them. We will provide a more detailed explanation of problems in comments we will file soon with the Commerce Department for its consideration in preparing the second report on implementation of the law. We would be happy to provide a copy of our comments to the committee.

Many of the problems that we have identified are minor and would require only technical amendments to the 1986 law. They evolve from incompatibility of the current law with existing insurance market practices and products. Others are more serious and stem from the law's failure to deal as specifically with purchasing groups as it did with risk retention groups.

A critical issue is whether policy forms and rates used by a risk purchasing group must be approved by all states where the group has members. A court decision in an Iowa case *(Frontier Insurance Company, Inc. et al v. William D. Hager, Commissioner of Insurance for the State of Iowa, U.S. District Court, Southern District of Iowa, 87-645-C)* held that a purchasing group is located in each state where it has insureds. This means that a purchasing group could be required to meet different policy and rate regulations in all 50 states.

We believe this interpretation contradicts Congressional intent and defeats the primary goal of the law, which was to enable groups to form without being subject to regulation in all 50 states. We believe that purchasing groups should be subject to regulation in their state of domicile, but only the domiciliary state should have the right to review risk purchasing group policy forms and rates. (However, we think that risk retention groups should be able to determine rates and design policy forms without approval of the regulator in the state of domicile. This is due to the different nature of risk retention groups as self-insurance mechanisms. They should be permitted to be licensed under state captive insurance statutes.)

One of the problems with the law is the definition of purchasing group location. We believe the purchasing group should have the right to select its location, or domicile, and

the regulator in that state should have primary jurisdiction. Regulators in other states where the group has insureds should have the authority to intervene only when they have concerns about the financial stability of the group's insurer and the primary regulator is not addressing these concerns. With this exception, we favor limiting the financial examinations of risk retention and purchasing groups to one per year unless ordered by a federal court, as permitted under the act. This would mean both types of groups would be subject to parallel financial regulation. We also support additional information filing requirements for risk purchasing groups.

Due to marketplace compatibility problems we support some limited expansion of coverage that groups can provide their members. For instance, we think risk retention groups should be allowed to provide all commercial motor vehicle and trucking coverage, including physical damage coverage, because these products are not separated in the traditional marketplace. If a group cannot offer physical damage coverage, its ability to provide the liability for this line is diminished. Similarly, we think risk retention groups should have the ability to provide excess employers' liability, because this coverage is usually offered in an umbrella liability policy. They should also be able to cover entities related to the group member which is being insured.

We think the risk retention group exemptions from securities laws should also be clarified. It should be clear that brokers and others who are helping clients establish risk retention groups are not required to be federally licensed as securities brokers. We also think the law should address the question of state filing fees. We believe that the state of domicile should be the only jurisdiction in which filing fees can be required.

We have seen confusion created by different filing forms in various jurisdictions. We recommend that the Commerce Department develop a standard filing form unless the NAIC acts to standardize this information filing procedure.

Finally, as was the case in 1986 when the law was being drafted, we are concerned about unreasonable regulatory scrutiny of risk retention and purchasing groups. We believe the federal government should have the authority to enjoin state action that unreasonably discriminates against group formation and operations.

Thank you for considering our views. I would be happy to answer your questions.

NAIB RESPONSE TO QUESTIONS FROM SEN. BRYAN
SUBMITTED BY LUCIEN P. LABORDE, JR.
ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS

Q: Your testimony identifies some financial standards that could be applied, specifically a capital-to-surplus ratio, and minimum capital and surplus amounts. You maintain that these standards should ensure that the insurer is financially stable. Please elaborate on that point.

A: As the record number of recent insurer insolvencies should indicate, no financial standards can offset the impact of mismanagement and imprudent underwriting. What these standards would ensure is that purchasing group insurers would operate within reasonable financial parameters that would support the possibility of adverse underwriting results.

Also, the establishment of clear national standards would simplify both the organization and regulatory process. The proposed guidelines are specifically designed to weed out "shoe string" operations. The standards proposed are generally utilized in both the insurance and regulatory communities. The 10:1 maximum capital and surplus to net per occurrence retention rations is the most restrictive and, arguably, the most important of the three criteria.

Q: Your testimony says that the "Location" of a purchasing groups should be clarified, and the regulator in that state then should have primary jurisdiction. Regulators in the other states then could intervene if they are concerned about the financial stability of the group and the primary regulatory is not addressing the concerns.

> **How would the second state determine that the primary regulator was not addressing the concerns? Do you suggest specific statutory standards for when the second regulator could intervene?**

A: The NAIB would support that the initial contract of the "second state" regulatory be made with insurance department officials of the state of domicile or location. The regulatory department of the state of domicile should have a reasonable time frame (suggest 30 days) to respond to the inquiry by providing: (1) a copy of the most recent statutory audit; (2) notice of intent to audit or of audit in progress; or (3) notice of no intent to audit.

We recommend that financial audits be limited to one per year unless a federal court order is obtained to the contrary. If the state of audit has not conducted and elects not to conduct an audit within the time frame noted above, any interested "second state" should have the ability to do so. We would also support the

expansion of this examination process to address not only financial impairment but also membership eligibility and business plan compliance with the provision that such examinations should be funded by premium tax receipts from purchasing groups and not by additional assessments.

Q: You state that you believe state filing fees should only be required from the state of domicile. Do you object to any filing fees (even modest ones covering administrative costs), or are you concerned because you feel that filing fee requirements have become a way to deter groups from forming?

A: We would support the established of a uniform modest filing fee for every state in which a risk retention group or purchasing group insurer wishes to provide coverage to a primary insured. We are most concerned with the multiplicity and variance of filing forms and fees. The insurance premium tax is a source of revenue to the states, part of which is used for oversight of all regulated activities. Therefore, paying premium taxes makes the filing fee redundant.

Q: You suggest that the federal government should be authorized to enjoin state action that unreasonably discriminates against group formation and operations. Please provide some examples of when you think it would be appropriate for this authority to be utilized.

A: The federal government, through the U.S. Attorney General's office, should have the ability to seek injunctions in federal court against states which are clearly discriminating against and operating in violation of the Congressional intent of risk retention and purchasing groups. Examples of activities subject to injunction would include:

1. Efforts by states, other than the state of domicile, to regulate rates and policy forms;
2. Efforts by states other than the state of domicile, to discriminatorily tax or assess risk retention groups and purchasing groups; and
3. Efforts by states to discriminatorily prohibit or inhibit the operation of risk retention groups or purchasing groups on a class basis.

Q: Are your members having difficulty finding affordable and available insurance for their clients? If so, what kinds of risks are hard to insure?

A: In spite of the "soft" market in the insurance industry, there are still a number of industries, classes and coverages with limited availability. This is predominantly because these have considerable liability exposures. We would note that availability is better than 1985 in almost all cases, but areas of continued restrictiveness include the following:

1. Physicians and surgeons (especially obstetricians and neurosurgeons);
2. Nurse midwives;
3. Day care centers;
4. Metropolitan hospitals;
5. Metropolitan government entities;
6. Environmental impairment liability;
7. Directors and officers liability (especially for large financial institutions);
8. Products recall liability;
9. Products liability for durable goods (especially liability for motorized/mechanical equipment and pharmaceuticals); and
10. Workers' compensation insurance (especially under the U.S. Longshoremen and Harborworkers Act).

Q: If a broker is involved in organizing a purchasing group, can that group obtain the best insurance arrangement possible or is there a conflict inherent in the situation? In other words, should there be a prohibition on brokers forming such groups?

-- Is it a good idea to have the broker disclose the fact that the broker is promoting the group?

A: The NAIB would be willing to support mandatory disclosure of the prime organizers of any risk retention or purchasing group, whether policyholders, insurance carriers, brokers, or investors. To restrict any of the above from the capacity as "organizers", however defined, would not only be anticompetitive and, thus, counterproductive to the intent of the Act, but would also deprive the groups of critical resources and expertise needed in formation and operation. Even under the Act, bringing a group together can be a relatively expensive and time consuming process.

There are legitimate business reasons for sponsorship of a purchasing group by a carrier or a broker, and the impact of those sponsorships is to provide a more competitive insurance market in terms of price and availability. A broker's role is professional intermediary between policyholders and insurance carriers. There is no inherent conflict in this role in any contract of independent parties. The role of the broker as intermediary will survive legislative, regulatory, and consumer scrutiny only so long as it provides value in excess of its cost.

Senator BRYAN. Mr. Laborde, we thank you very much for your testimony.

Gentlemen, it strikes me that what we have is a desire on the part of the Congress, to which I am sympathetic, to extend and provide an additional option to make insurance in some critical areas more available and more affordable. Having lived through the so-called insurance crisis, whatever its genesis, contrived or a product of the marketplace, it certainly was real for businessmen and women in particular who were seeking insurance in some of the critical fields that have been mentioned here in your testimony and in some of the questions that have been propounded by other members of the subcommittee.

I am very sympathetic about your concern about the blizzard of paperwork. That is something that has never appealed to me.

On the other hand, however, Mr. Mullen, I will ask this of you: What should be the authority of the insurance commissioner of a state in which a purchasing group or members of a purchasing group operate, not the state in which it is domiciled, not the principal state. How does the insurance commissioner respond to the person in his state who says, look, I thought I had acquired a certain coverage, someone came through one evening and presented this package to me, I signed up with it, now I am looking to you to do something about it.

It seems to me that the response falls a little hollow for the insurance commissioner to say: Well, let me tell you about the provisions of the Liability Risk Retention Act of 1986. Under that Act, we have to defer to the good judgment of state X, where this particular group is domiciled, and we have very little control.

I find it hard to believe, that that situation is in the best interest of the business community which seeks this additional coverage. Should there not be an ability to inquire about financial solvency? The kind of comment that Mr. Gates—and I do not know whether you could hear his comment, Mr. Mullen, but to take a look to see whether they keep their records so that they know whether this company really is keeping a list of the number of policies, the number of claims that have been filed, how they handle their claims.

It strikes me that citizens in each of the respective states fully expect that their insurance departments exercise that kind of protection for their benefit. Please respond to that broad philosophical inquiry.

Mr. MULLEN. Well, it is a very good question, Mr. Chairman. Let me respond to what I think are two critical points.

First, from the operational standpoint, the operational problem that the insurer of a purchasing group faces if it is subject to traditional regulation is the burden of getting its policy forms approved in all 50 states. Let me give you just one illustration. A typical policy has a provision that will say that the insured must give immediate notice of any claim made against the policyholder. Well, some state insurance department might say, we do not like the word "immediately," we think you should use the word "promptly." And another state will say, well, we do not like "promptly," we think you should use the words "as soon as possible." And so here you are, trying to develop a common program, to use Mr. McIn-

tyre's example, the American Bar Association, let us say hypothetically, trying to create a professional malpractice program for lawyers, and the group is trying to get all of this policy wording preapproved. That is one operational problem.

Senator BRYAN. I must say, I think you make a persuasive point there. I am not impressed with that argument, either, that we need to dance around "promptly," "immediately," "as soon as possible," all of those kinds of subtleties.

Mr. MULLEN. So that is one problem.

But the other aspect of your question that you raise. I do not defend any fraudulent conduct or any operations by any company that is operating in a hazardous financial condition. And we would propose—the National Risk Retention Association supports additional financial regulation along the lines of the Department of Commerce. We have included that in our testimony and draft legislation.

NRRA would say that the insurer of a purchasing group, although it should be free, from the rate and form filings, it should include information filings of those forms. If there is anything fraudulent or clearly misleading about them, the group should not be permitted to operate.

With respect to the financial condition, the purchasing group's insurer should have to file copies of its annual financial statement. It should be certified by a CPA, contain a statement on loss reserves by a qualified actuary, and each state insurance department should have the right to find out about the financial conditions and the management of any insurance company of a purchasing group and enjoin that group immediately if it is in a hazardous financial condition. If the insurer cannot show that it has enough funds to pay the reasonably anticipated claims that are going to be made under its programs it should not be permitted to continue doing business.

Senator BRYAN. This question I ask of any of you. Should an insurance commissioner have the right to examine office procedures? I am not talking about where the typewriters are placed or what type of computer equipment is on line, but to ascertain whether or not the group in fact has the ability to process claims, to take a look and to examine?

And if you concede that that right is something that the insurance commissioner ought to have, who bears the cost of that? Should not some reasonable fee be chargeable? And again, I do not endorse, if indeed the evidence supports it, fees that are so high that at least the apparent purpose would be to discourage, as opposed to compensate for the regulatory function.

But who should bear that burden? Should the residents of the State of Nevada or Iowa or any other state bear that cost, without some ability to recoup the fee when the insurance commissioner's ostensible visit to the domicile, the principal place of residence, is to ascertain that indeed this company has the ability, not just from what is on the filing but otherwise, to process the claims?

Mr. Bossman, you look like you are geared for this one.

Mr. BOSSMAN. Well, we assumed that the Iowa department was fully qualified and able and responsible for regulating our company, and they do. And we had an audit that cost us somewhere be-

tween $6,000 and $8,000 this past year. I am assuming that, if Iowa refused to do that, that some other state who thought that we were in financial impairment would then have that right to do that.

Senator BRYAN. Sure, but who would bear the cost, Mr. Bossman?

Mr. BOSSMAN. Iowa charged me for it.

Senator BRYAN. I certainly do not impose any suggestion that Iowa is not doing an adequate job. I am using some hypotheticals.

Mr. BOSSMAN. I am assuming that if Iowa did not and another state would come in, they would charge me for that cost, just like Iowa charged me for that cost.

Senator BRYAN. So that they should have that ability to, in effect, recoup the cost of the investigation, the trip to Iowa or wherever this particular purchasing group may be domiciled, so that one could examine to take a look and see if the ostensible claim in the filing bore any relationship to the reality of the experience?

Mr. BOSSMAN. Well, I have got a risk retention group and not a purchasing group. My only concern about that is the commissioners, if they chose, under that broad scenario they could all take their turn, come in and charge me and could price me right out, inspect me right out of business.

Senator BRYAN. I guess what I am asking you to consider is to balance. Understand that the insurance commissioners have a responsibility under their laws to protect the residents of that state, and that is not an unreasonable expectation.

The public, when a problem develops—and a lot of us have been in the arena where those problems develop—looks to the insurance commissioner, looks to the governor, and says, where were you? Why should we let the insurance commissioner in Iowa or some other state do that? Again, I want to be very clear, Mr. Bossman, I am not suggesting that Iowa's insurance regulation is not up to standard. But that is a concern.

Mr. Laborde, you seem to have a comment. And I see we have been rejoined by Senator Kasten, who I am sure has some questions to ask. Yes.

Mr. LABORDE. Thank you, Senator Bryan. I just want to point out, we would certainly hope that the premium taxes that are being paid by these companies are not being lost in a bottomless pit. They are an appropriate payment or source of revenue for regulation of groups.

The second part is we believe——

Senator BRYAN. Well, let me just stop you there, and we will get to the second part. You are saying that no ability, as Mr. Bossman suggests, to recoup the expense of the investigation should be permitted, that that ought to be written off under the umbrage of the premium insurance tax that might be collected in that state?

Mr. LABORDE. That is correct. Those premium taxes are imposed for the provision of government services, and this is an example of the type of government services that they should be purveying.

The second issue is we believe the situation described by Mr. Bossman. The state of domicile has the first responsibility for certifying the financial, the hazardous condition, of a group. If that action is not taken then another state has the opportunity to step

in. We would support having that authority expanded to areas such as operational issues and also certification that the membership qualifies within the letter of the Risk Retention Act.

Senator BRYAN. Mr. Laborde, we thank you for your response.

Senator Kasten.

Senator KASTEN. Mr. Chairman, I am sorry I am spending time on the phone and doing three or four other things at the same time.

But I just have one question for Mr. Mullen. I could have asked this question, but I did not, to the National Association of Insurance Commissioners representative. It seems to me that if they so desired, that they could develop a form, a common registration form, if you would.

If it were developed with the elements that they needed—let them work it out amongst themselves as to exactly what they need. Would you be willing to work with them on a national form, and would that not solve a lot of these problems?

In other words, let them put together an executive committee of some kind to determine what is needed. It is not true that there is information that they are asking for that you are unwilling to provide. It is true that the information that they are asking for is different in every jurisdiction, am I right?

And would that system work, and have you explored that with them?

Mr. MULLEN. Well, in answer to your question, yes, I think there would be merit to trying to develop a common registration form, a simplified form, assuming that it only requested the information that is required under the Risk Retention Act and did not have a lot of additional information.

We have explored that on a couple of occasions, but have not really pursued it very far with the NAIC. But I think it would be a good idea.

It would not, however, solve all of the problems, because there are still other problems, as I mentioned in answer to a question of the chairman, regarding the approval of the wording of policy forms and the amount of taxes, the method by which you pay taxes, whether or not a company is authorized to engage in direct offering of insurance by mail, and so on, the conditions under which that can happen. So there are other problems.

But that would be a valuable initiative.

Senator KASTEN. That could take place without any legislation? That could take place without even a letter. That could take place with just some of the individuals from the groups that you are representing getting together with some of the individuals that were represented by the previous witness, Mr. Gates, and simply saying, okay, let us develop a common form and see if we cannot at least get through this part of it, am I right?

Mr. MULLEN. That is correct.

Senator KASTEN. Mr. Chairman, that might be something that at the end of these hearings, after we have had a chance to digest the testimony, that we might be able to expedite it. It might be a step, it might be a positive contribution.

Senator BRYAN. Senator Kasten, I did when you were out of the room express some sympathy with the concern that they are

having with the bewildering amount of paperwork and the conflicting different application forms and formats. I am sensitive to that.

I have some other concerns that this group knows, that I have registered with them.

Senator KASTEN. I said in one of my previous questions to Mr. Gates that the fees range from $50 to $1,000. Alaska is the state, I am told, that has the $1,000 registration fee. Are these fees in your opinion designed to prohibit or, I should say, to be a strong disincentive in terms of the formation of risk retention groups?

And are these fees consistent with other registration fees of similar kinds of insurance companies?

Mr. MULLEN. Let me briefly comment on that. I read a report in one of the insurance trade journals just the other day, that a representative of the Alaska insurance department stated that that $1,000 fee is the same fee that they apply to other companies who become licensed in the State of Alaska. There is a couple of problems we have with that. Number one, if all the states charged $1,000 that would be $50,000. That to a new startup company is a fairly tough bite. And, if the purpose of the Risk Retention Act is to exempt the companies from having to become licensed in each of the 50 states, then, in our view, that is sort of a back door licensing fee. I am not sure that the states necessarily have an evil motive in doing this, but the effect is nevertheless adverse.

Senator KASTEN. Not only adverse. The effect is to violate the spirit of the legislation when we passed it in '81, which was to avoid these cumbersome registration processes.

Mr. MULLEN. That is true. And the other thing is, in some cases the groups may only have a small number of members, or a small amount of premium in a particular state, a less populous state, for example. If required to pay the $1,000 fee, fill out a lot of different forms, and do a lot of other things, some groups will just decide they are not going to do business in that state. To that extent, the fees discourage the full utilization of the Act.

Senator KASTEN. Mr. Chairman, I thank you very much.

Senator BRYAN. Thank you very much, Senator Kasten, and those questions will be included for the record, and we will ask our witnesses to respond accordingly.

Thank you very much for your presentations here this afternoon. We appreciate it.

Our final panel consists of: Mr. George Shaffer, who is President of the Insurance Center, Inc.; Mr. Karl Koch, President of Savers Property and Casualty Insurance Company; Mr. John Salisbury, Chief Executive, Housing Authority Risk Retention Group.

Mr. Shaffer, we will begin your panel's testimony with you, sir.

STATEMENT OF GEORGE SHAFFER, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA AND THE NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS

Mr. SHAFFER. Thank you very much, Mr. Chairman.

As you mentioned, I am from the Insurance Center, Inc., in Albuquerque. I am also Chairman of the Government Insurance Committee of the Independent Insurance Agents of America, and I

appear today on behalf of both the IIAA and the National Association of Casualty and Surety Agents.

Mr. Chairman, I take particular pleasure in appearing at this hearing. In 1986 I testified on behalf of the same associations when the Senate Commerce Committee was then considering amendments to the Liability Risk Retention Act.

Senator Kasten mentioned the White House Conference on Small Business. Succeeding that testimony in March, and I do not believe it was related to that, but I was appointed by the White House as commissioner of the insurance issue for the White House Conference on Small Business and presided over six regional meetings and one national meeting in front of 1,800 small businessmen.

I can assure you that I still feel the wrath of their ire with the insurance industry. The opening comment when they gave me the gavel was: I do not know why you gave me this; I asked for a handgun. But nevertheless, I am fully familiar with the problems of the hard market in the insurance business.

I also would like to endorse Commissioner Gates' concern for the average consumer, because as the agent we stand between the insurance company and the consumer and feel we represent both.

Two principles have guided our views on the risk retention legislation. First, we have always recognized our obligation as independent insurance agents to seek out what is best for our customers.

Second, as we said in 1986, as we say today, strong and effective state regulation is required to ensure that risk retention and purchasing groups are soundly managed, adequately funded, and well regulated.

The Federal government has not and cannot assume the responsibility of overseeing the day to day activities of such groups. Thus, our message today repeats what we said three years ago.

We can support changes in the Risk Retention Act that strengthen state oversight and enforcement efforts. We will oppose any changes that weaken state authority. Our written testimony discusses in detail several questions concerning the Risk Retention Act.

Today, however, I would like to focus on one issue, the application by states of their agent licensing laws. The 1987 Commerce report proposes that full-time employees of risk retention and purchasing groups should be able to sell and service insurance policies without being required to be licensed as an agent or broker in any state.

Insurance agents are licensed professionals, like lawyers or accountants. Yet, for the first time that we know of, the Federal government would be saying hands off to a state that merely wants to apply its professional licensing laws in a fair and evenhanded way.

This is not a question of Federal versus state authority. The Commerce proposal would permit unlicensed persons to be free from any regulatory oversight, state or Federal. That would be wrong.

There is no reason to even briefly consider such an extraordinary attempt to displace state regulation of insurance agents and brokers. Licensed insurance agents are subject to a number of education, certification, and licensing requirements.

Insurance customers could risk serious financial injury if they were denied the opportunity to consult a skilled professional with detailed knowledge of the insurance marketplace.

You do not have to just take our word for it. In March, the Kentucky Department of Insurance wrote to the Department of Commerce objecting to this provision in the new 1989 staff proposal. Let me quote just one passage from that letter:

> Agent licensing is an area where the proposed amendments reach a heighth of contradiction, in that, while states supposedly have authority to regulate risk retention groups and purchasing groups in certain areas, the inability of states to require agent licensing eliminates or substantially reduces the ability of states to exercise that authority.

The letter goes on to explain specifically how state protection of consumers will be curtailed by the Commerce proposal.

Now we have heard the assertion that risk retention and purchasing group members will always be sophisticated buyers who do not need the services of a licensed agent. But that argument cannot be taken seriously. First, it is not obvious to me that members of purchasing groups have more knowledge of insurance than any other buyers of personal and commercial insurance.

Second, even sophisticated customers deserve quality service. I have a lot of corporate clients to whom I have sold a considerable amount of commercial insurance over the years. Is it likely that Congress would grant me an exemption from all state licensing laws as long as I promise only to sell to those clients?

I do not think so, and that is because many sophisticated people still remain ignorant about the fine points of insurance and because licensing requirements cannot be applied on a case by case basis.

As importantly, the purported sophistication of the insurance customer does nothing to satisfy the enforcement requirements identified by the Kentucky Department of Insurance.

In sum, we see little need to criticize Congress for the job it did in 1986. Of course, almost any law can be improved and we would be pleased to comment on any concerns held by members of this committee about implementation of the Risk Retention Act.

But the bottom line should be clear: Regulatory authority left to the states in 1986 should not now be disturbed. The very best way to protect the members of risk retention and purchasing groups is to ensure that state regulators continue to have the necessary authority to regulate these groups and their insurers.

Thank you.

[The statement and questions and answers follow:]

STATEMENT OF GEORGE R. SHAFFER, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC., AND THE NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS

Mr. Chairman, my name is George R. Shaffer. I am an independent property/casualty insurance agent from Albuquerque, New Mexico, and I serve as Chairman of the Government Affairs Committee of The Independent Insurance Agents of America, Inc. ("IIAA"), the nation's largest independent insurance sales and service organization. I appear today on behalf of both the IIAA and The National Association of Casualty & Surety Agents, which represents the largest commercial property-casualty agencies in the United States and of which I am a member.

Mr. Chairman, I take particular pleasure in appearing at this hearing. In 1986, I testified on behalf of the same associations when the Senate Commerce Committee was then considering amendments to the Liability Risk Retention Act.

Two principles have guided our views of this legislation. First, we have always recognized our obligation as independent insurance agents to seek out what's best for our customers. During the hard market in 1985 and 1986, we heard plenty about the problems caused when liability insurance becomes unavailable or unaffordable.

Second, we have taken a consistent view of the means that will best protect insurance customers. We said in 1986, as we say today, that strong and effective state regulation is required to ensure that risk retention and purchasing groups are soundly-managed, adequately-funded and well-regulated. To be sure, the Risk Retention Act provides initial authorization for the existence of risk retention and purchasing groups and, to the extent necessary to accomplish that end, preempts state laws.

But the federal government does not--and cannot--assume the responsibility of overseeing the day-to-day activities of such groups. And nothing in the 1986 amendments contemplated wholesale federal displacement of traditional state regulation.

Thus, our message today repeats what we said three years ago. We can support changes in the Risk Retention Act that strengthen state oversight and enforcement efforts. We will oppose any changes that weaken state authority.

* * * *

Let me begin by identifying one trouble spot that has emerged in the last three years. In order to protect purchasing groups, state regulators must be able to monitor the solvency of insurance companies that underwrite the purchasers' risks. It is reported, for example, that perhaps 60% of the insurance companies providing coverage to purchasing groups are neither listed nor rated by the A. M. Best Co. "Potential For Abuse Clouds Purchasing Groups' Future," Business Insurance, p. 89 (Oct. 31, 1988).

Luckily, however, no reform of current law is needed in order to provide states with sufficient authority to protect their citizens. Federal courts in New York and Iowa have applied current law to uphold the right of states to require purchasing group insurers to file rates and forms and be an admitted company or an eligible surplus lines carrier in a state in which the purchasing group has members. See Insurance Company of Pennsylvania v. Corcoran, 850 F.2d 88 (2d Cir. 1988); Frontier Insurance, Inc., et al. v. Hager, No. 87-645-E (S.D. Iowa April 27, 1988).

99-266 - 89 - 6

These decisions are precisely correct. I participated in the 1986 debate. The only intent of the law was to keep state laws from prohibiting the formation of purchasing groups. Subsequent regulation was left to the states.

Some have criticized these decisions as placing unnecessary administrative requirements on purchasing groups. But any ministerial burdens pale in significance to a state's interest in securing the solvency of the insurers and protecting the welfare of its citizens. In the Iowa case I mentioned, the court was careful to note the benefits of requiring the insurers of a purchasing group to comply with state law. A purchasing group insurer admitted in Iowa provides its members with the additional protection of Iowa Guaranty Fund coverage in the event that the insurer becomes insolvent. And even non-admitted surplus lines companies are subject to certain state oversight.

We have always regarded the protection of insurer solvency as a key issue to be confronted when alternative insurance mechanisms are employed. But in current times, the importance of the solvency issue cannot be overstated. On the House side, the Energy & Commerce Committee is examining the causes of the Transit and Mission insolvencies, among others. Chairman Dingell has blamed insolvencies on mismanagement and misconduct at the highest levels of corporate decision-making. And the chief executive of one insurance company recently asserted that the problems of potential insolvency in the

insurance business can be compared to the current problems of the savings and loan industry. "Insurer Solvency Woes Similar to S & L Crisis," National Underwriter, p. 4 (April 17, 1989).

This is scarcely the time to impede--rather than encourage--state regulation.

Nonetheless, a draft proposal from the Commerce Department takes exactly that position. Normally, we would not address a staff proposal that has not even been finalized, much less introduced in either house. But, because the proposal was included in the 1987 Commerce Department report to Congress, we believe that this Committee should understand, at the outset, that it is deeply flawed.

The Commerce draft would set minimum standards for a purchasing group insurer but would effectively permit additional regulation of that insurer only by the state in which the purchasing group has its "principal place of business," which does not have to be the same state in which the insurer itself is domiciled. Rather, the proposal would permit the purchasing group to choose as its "principal place of business" any state in which it has any members.

That makes no sense. First, it is illogical to give an insurance company and its customers the power to circumvent regulation by the home state of that company, which is in the best position to monitor its activities.

Second, the "principal place of business" standard can be easily manipulated by any purchasing group able to find members in more than one state. In our view, states should not

be able to compete for the privilege of providing the least rigorous regulation. In this situation, insurers of purchasing groups, just like all other insurers, should be subject to reasonable regulation by the states where their insolvency could have an adverse impact.

Let me give an example. Suppose that an insurance company is domiciled in Arizona and provides insurance to a purchasing group. Most of the purchasing group's members live in Nevada, but a few live in Texas. Under the Commerce proposal, the purchasing group would be free to designate Texas as its principal place of business. That would limit the ability of both Nevada, the home of most of the members, and Arizona, the home state of the company, to protect their consumers. That result should not be permitted.

* * * *

I said at the outset that we will oppose any changes that weaken state authority. And that means that we will oppose vigorously any attempt to allow unlicensed persons to act as insurance agents and brokers.

The Commerce staff proposal takes a contrary, and in our view, unsupportable view. It proposes that full-time employees of risk retention and purchasing groups be able to sell and service insurance policies without being required to meet the educational and licensing requirements of an agent or broker in any state.

The reach of the proposal is startling. Insurance agents are licensed professionals, like lawyers or accountants or doctors. Yet, for the first time that we know of, the federal government would be saying "hands off" to a state that merely wants to apply its professional licensing laws in a fair and even-handed way.

This is not a question of federal versus state authority. The Commerce staff proposal would permit unlicensed persons to advise insurance consumers about the meaning of complex insurance products free from any regulatory oversight, state or federal.

There is no reason even to briefly consider such an extra-ordinary attempt to displace traditional state regulation of insurance agents and brokers.

Licensed insurance agents are subject to a number of education, certification and licensure requirements ensuring that we deliver quality service to our clients. We stand between the insurer and the customer. Insurance customers could risk serious injury if they were denied the opportunity to consult a skilled professional with detailed knowledge of the insurance marketplace.

You don't have to take just our word for it. In March, the Kentucky Department of Insurance wrote to the Department of Commerce objecting to this provision in the staff proposal.

Let me quote just one passage from that letter: "Agent licensing is an area where the proposed amendments reach a heighth of contradiction in that, while states supposedly have

authority to regulate risk retention groups and purchasing groups in certain areas, the inability of states to require agent licensing eliminates or substantially reduces the ability of states to exercise that authority. For example, if an agent commits an error in marketing coverage on behalf of a risk retention group or a purchasing group's insurer, a state can call upon the agent to correct that error under penalty of loss of license. Under the proposed amendments, this control is lost." Letter of Patrick Watts, General Counsel, Commonwealth of Kentucky, Department of Insurance to Edward T. Barrett, II et al., Office of Economic Affairs, United States Department of Commerce (March 29, 1989).

The Commerce proposal includes another equally wrong-headed attack on the application of agent licensing laws by suggesting that states be prohibited from requiring the use of a local agent by risk retention and purchasing groups. But that change would equally impair the state interest in supervision of insurance sales within its borders.

Now, we have heard the assertion that risk retention and purchasing group members will always be sophisticated buyers who do not need the services of a licensed agent. But that argument cannot be taken seriously. First, it is not obvious to me that members of purchasing groups--which include nurse-practitioners, small businessmen and others--have more knowledge of insurance than any other buyers of personal and commercial insurance. Why shouldn't they get the same protection?

Second, even sophisticated customers deserve quality service. I have a lot of corporate clients to whom I have sold a considerable amount of commercial insurance over the years. Is it likely that Congress would grant me an exemption from all state licensing laws as long as I promise only to sell to those clients? I do not think so. And that is because many sophisticated people still remain ignorant about the fine points of insurance and because licensing requirements cannot be applied on a case-by-case basis.

As importantly, the purported sophistication of the insurance customer does nothing to satisfy the enforcement requirements identified by the Kentucky Department of Insurance. There is no reason for Congress to consider any amendment to the Risk Retention Act that would exempt risk retention and purchasing groups from the application of any state agent licensing law.

* * * *

In sum, we see little need to criticize Congress for the job it did in 1986. Of course, almost any law can be improved and we would be pleased to comment on any concerns held by members of this Committee about implementation of the Risk Retention Act.

But the bottom line should be clear: Regulatory authority left to the states in 1986 should not now be disturbed. The very best way to protect the members of risk retention and purchasing groups is to ensure that state regulators continue to have the necessary authority to regulate these groups and their insurers.

ANSWERS TO SENATOR BRYAN'S QUESTIONS -- RISK RETENTION HEARING

by George Shaffer for IIAA and NACSA

Q) Your testimony advocates continued strong state regulation of insurance. Others testified that the states have been impeding the implementation of the Risk Retention Act. How do you answer the criticism of the other witnesses?

A) I agree that states should not be able to impede the formation of risk retention and purchasing groups. But, because it is very important that states monitor and regulate these groups, we should not take away the ability of each state to promulgate those regulations that it feels necessary to enable it to obtain the appropriate information from which to ascertain the group's financial stability in order to protect that state's consumers.

Some will argue that members of risk retention groups (RRG's) are usually more sophisticated consumers with only their own money at risk, as opposed to the consumer who purchases insurance in the standard marketplace with the backup of the state guarantee fund. However, I will state as I did in my testimony that members of RRG's deserve the same quality protection as the standard consumer.

I also have a great deal of concern about restricting each state's ability to regulate the insurers of purchasing groups (PG's). I think the type of consumer involved in a PG differs markedly from a RRG. In addition, in many cases the state guarantee funds could be at risk. What is of equal concern is that in other instances, claimants are left without recourse against supposedly insured occurrences.

Q) Are your members having difficulty finding affordable and available insurance for their clients? If so, what kinds of risks are hard to insure?

A) The most readily apparent insurance that members of IIAA and NACSA are finding difficulty in writing is insurance to cover the financial responsibility provision of the new E.P.A. regulations governing underground storage tanks. At this point, there are only two or three companies or RRG's that will even write this type of coverage and it is quite expensive.

This is an extremely risky field with a great potential for loss. Even the states are having trouble establishing some type of state-sponsored insurance program in accordance with the law,

because of the enormous risk involved. I do not believe any further change in the Risk Retention Act will make this type of insurance any more readily available.

Also, some members have cited problems writing workers' compensation, pollution, and professional D & O (directors and officers) insurance.

All that being said, you must keep in mind that we are currently in a "soft market" for insurance, meaning that in most cases insurance is readily available at an acceptable price. Unfortunately, due to the cyclical nature of insurance business, these conditions may not last. When the cycle begins to change and we move back into a "hard market", insurance prices will rise and consumers will again complain.

Q) Your testimony criticizes certain proposals that full-time employees of groups be able to sell insurance policies without using a licensed agent. What specific benefits can a licensed agent provide that such an employee could not?

A) A licensed agent or broker must meet educational and licensing requirements for each state in which he or she wants to do business before he or she is allowed to sell or service insurance products within that state. The insurance commissioner in each state sets up the requirements to ensure that the insurance-buying public is adequately protected. The customer comes to the agent or broker to have an insurance package put together that will meet that specific customer's insurance needs in accordance with the insurance laws of that particular state.

One of the best controls a state has to protect consumers against unscrupulous persons is its licensing of the people who sell the insurance product. The risks could be great if unlicensed persons, not versed in the technicalities of insurance laws, are allowed to market and service insurance products for the first time. Products could be sold that do not meet the minimum necessary requirements for insurance in that particular state, thereby leaving the consumer under-insured, or worse uninsured, against claims from which he thought he was protected.

Q) If an agent organizes a purchasing group, can that group obtain the best insurance arrangement possible, or is there a conflict inherent in that relationship? In other words, should there be a prohibition on agents forming such groups?

--Is it a good idea, as Mr. Koch suggests, to have the agent disclose the fact that the agent is promoting the group?

A) I'm not sure I understand the concern that you raise. There is no more chance of a conflict of interest when an agent is placing insurance for a purchasing group than in any other instance when the agent is finding insurance for a client. Customers seek out an independent agent because the agent, who may write for several different companies, works for the insurance-buying consumer and puts his insurance needs first. In addition, the independent agent is usually equipped to assemble an insurance package tailored to each consumer's needs.

I am not sure I understand Mr. Koch's concern. But IIAA and NACSA surely do not oppose an agent's disclosing that he is placing insurance for a purchasing group.

Q) Your testimony objects to proposals that regulation of purchasing group insurers be limited to the place where the group has its principal place of business, because groups should not be able to shop around for the state with the least regulation. Would that objection be answered by some kind of minimum regulatory standards, such as capital requirements?

A) I think one of the main points in my argument has been lost. Yes, I am concerned that insurers will establish or join together with purchasing groups to find the state of "least regulation" in which to establish the purchasing group's principal place of business. However, I am more concerned that each state have the ability to regulate and monitor the insurer of the purchasing group, in any state which the purchasing group operates, in order to protect its consumers.

Allowing states to monitor and regulate these insurers does not hamper or impede the establishment of the purchasing group. Nor is state regulation designed to inhibit the establishment of these groups. It merely ensures that any company wanting to write the business of the group members in that state meet the standards established by the state, for the public's protection.

My real concern with any type of minimum financial standards is this: who would establish those standards, and then, and more importantly, who would monitor their compliance--the federal government? I cannot reiterate often enough that the states are most able to know what requirements are necessary to protect their consumers.

In addition, the current proposed capital requirements do not go far enough, or give enough information about the purchasing group's insurer to enable the state's insurance commissioner to feel confident that the consumers of the state are adequately protected.

Again I go back to my argument that the insurance

commissioners are not hampering the formation of purchasing groups themselves, but merely attempting to derive necessary information from the company insuring the purchasing group. I have trouble understanding the claim that by trying to protect their consumers, the states are somehow acting improperly.

Q) In 1986, you expressed concerns about the legislation that ultimately became law because you saw it as the "nose under the tent" to have federal, rather than state, regulation of insurance.

-- Do you feel this has happened? Why or why not?

-- Do you still have similar concern?

A) Due to effective regulation and monitoring of both risk retention groups and purchasing groups by the states, the need for federal intervention has been eliminated.

However, what concerns me now is that rather than give this law time to work, some groups are once again pushing changes that would allow less state regulation. It appears to me that these may be the very same groups who stand to profit a great deal should many of the current state restrictions be lifted. However, these actions may not be in the best interest of the American consumer. Instead, we should give the states time to adjust and find their own equilibrium within the parameters of the present law.

If states were left powerless to act, which is a distinct possibility under some of the proposed changes in the law, possible unscrupulous actions by some associated with RRG's or PG's, could very well lead to federal intervention.

Unfortunately, the push still appears to be on to have the federal government, not the states, responsible for the oversight and regulation of insurance. One needs only look at the current clamor, at both the state and federal level for the repeal of the McCarran-Ferguson Act, created, it seems, by those who have little or no understanding of the insurance business. However, I argue again that it is the states that are most able to understand the needs and concerns of their own consumers and the laws required to protect those consumers, and therefore the states should continue to be allowed to monitor and regulate insurance as each deems necessary.

Senator BRYAN. Thank you very much, Mr. Shaffer.
Mr. Koch.

STATEMENT OF KARL W. KOCH, PRESIDENT, SAVERS PROPERTY AND CASUALTY INSURANCE CO.

Mr. KOCH. Good afternoon, Mr. Chairman.

I am Karl Koch, President of Savers Property and Casualty Insurance Company of Overland Park, Kansas. We appreciate the opportunity to appear before this subcommittee today to tell you about our experiences in operating throughout the country two risk purchasing groups.

One insures school teachers and we have approximately 20,000 school teachers insured for professional liability. Our other purchasing group insures real estate appraisers and we have approximately 1500 real estate appraisers insured.

We echo the opening statements from you, Senator Bryan and Senator Kasten, that the intent of the Risk Retention Act was to provide small insureds the benefits of making insurance more easily available. We think that the Risk Retention Act has gone a long way toward accomplishing this in most states, but that in a few states this objective has virtually been unobtainable.

I have enjoyed the benefit of seeing the Risk Retention Act from two perspectives. I was Executive Vice President of the National Association of Insurance Commissioners from 1985 to 1987, when the Act was being considered. In early '88 I became President of Savers Property and Casualty, which operates exclusively in the purchasing group arena. So I had the benefit of seeing the law originally from the regulatory side and secondly from the operational side, as seen by the industry.

We believed that our filing to operate in a state should go through very easily. We are admitted in Illinois, Kansas, and Missouri. We have capital and surplus of $12.5 million. We will write only about $7 million in written premium in 1989.

We are owned by Franklin Savings and Loan, which has assets of $13.4 billion and stockholders equity of $408 million. We retain a maximum of $250,000 on any one occurrence and maintain reinsurance with A-plus reinsurers exclusively.

The two groups we write, the real estate appraisers and the school teachers, are excellent representatives of the need for the Risk Retention Act. Both of these groups share some characteristics that we believe the Risk Retention Act was intended to address.

One, they are small premiums. Each individual risk is small premium, and even for the purchasing group as a whole it is a relatively small premium.

They are comparatively volatile risks, meaning that each has the potential for a severe loss, coupled with lack of truly credible premium size.

Thirdly, these risks are scattered throughout the United States and many states have only a few insureds, possibly only two, five, or ten insureds, making it very difficult to go through many hurdles of state regulation to make it profitable or even attractive to try to insure these.

We think the Risk Retention Act was designed to provide available insurance for these type of insureds. We are sympathetic with state regulators and we recognize their need to monitor activities of purchasing groups. As I indicated earlier, most states seem to perform these accountabilities in a responsive manner.

A significant number of states, however, continue to create such obstacles that we believe strengthening of the Risk Retention Act is mandatory. To illustrate some of these hurdles, we attached to our testimony appendix 1, which gives various positions taken by state regulators. These are based on correspondence we have received.

To illustrate how frustrating it can be on occasion, we have also attached as appendix 2 selected correspondence to two states which detail the multitude of steps and hurdles gone through in an effort to become approved.

An estimated 40 states have responded to our initial filings, which were in 1987, to operate these purchasing groups. Many of these did not respond until late 1988, until after the Frontier decision in Iowa defined the term "located."

Almost all of the responding states required us to obtain surplus lines approval. Wherever that was requested, we endeavored to do it.

A few states gave us such approval in literally a matter of days or weeks, such as Iowa and Illinois. In several other states, after 18 months of correspondence, telephone calls by many people, employment of counsel, we are still trying to obtain approval as an E&S carrier.

I would like to address some of the specific areas if I may. Filing fees. Filing fees do not appear unreasonable until you consider that several states have very few insureds participating in a given purchasing group.

We have encountered a fee of $1,050 in one state—for filing the annual statement each year. They apply it to surplus lines carriers and admitted carriers evenly, so it is not discriminatory to the purchasing groups.

We do not have enough insureds in the state to pay them $1,050. Therefore, we decided we likely will stop writing business in the state, purely based on an economic decision.

Another issue of concern is paperwork. Other witnesses have testified about the duplicative paperwork that must be gone through. Some require the same information; they just want it in a separate sequence, or they want it on their own form. Some require things that other states do not.

The information, again, is not necessarily unreasonable or difficult to get, but when it comes in 50 different directions with 50 different forms it becomes economically not viable.

The issue of rate and form filings has come up. It is my belief after 20 years in the industry that the marketplace tends to regulate rates very well. People are sophisticated enough to price shop. They tend not to buy insurance that is high priced, particularly purchasing groups, which typically have an association, formal or informal, to represent them. They look for an association endorsement and they talk to each other at meetings. They will not buy insurance that is excessively priced or that has poor coverage.

Most importantly, the credibility of a rate filing in a state that has, say, ten insureds is an absolute farce. There is no credibility. In this case rates have to be based on a national level. All the rate filing would do is offer an opportunity for those few states who seek to thwart the company operating to use the rate filing as a way to slow things down.

We recommend certain modifications to the Act. We think the most important is to define the principal place of business as the one state the purchasing group selects. That choice would determine which state would regulate the ongoing operations of the purchasing group.

We think all other states should be preempted from regulating the purchasing group insurer for such things as policy forms and rates, but I want to stress, but not for financial integrity. I believe, and I think many insurers believe, and I have heard many witnesses today state, that any state, if they judge the company to be in hazardous financial condition, should have the authority to step in and take whatever actions they deem necessary.

I believe that if the Act specifies this for purchasing groups, it might go a long way to alleviate insurance department objections.

We believe the Act should establish minimum standards. Otherwise, purchasing groups will congregate in the weakest links in state regulation. Minimum standards for capital and surplus, maximum net retention per occurrence for the insurer, restricting writings to carriers under the jurisdiction of the U.S. judicial system and under state insurance regulation would go a long way toward keeping those few bad guys from successfully operating.

We see several questionable proposals: a proposal in the Commerce draft of January to require a purchasing group to maintain an office in the state of domicile. That is fine if the purchasing group is a formal association. Many purchasing groups are not formal associations, but in fact are linked only by a common interest, such as real estate appraisers have many associations, but we insure appraisers who are in the association or who are not.

Secondly, there is a proposal that purchasing group insurers participate in risk pooling arrangements. This too is insidious. In writing some risks, the purchasing group carrier may be writing a very high percentage of the risk insured.

Senator BRYAN. Mr. Koch, I do not want to be rude and cut you off here, but if you can summarize. We have got the benefit of your prepared testimony. There may be some points that you want to at least just bore home on. Let me give you a few seconds to wind it up, if you would.

Mr. KOCH. I thank you, Mr. Chairman. I think I have made my points.

We just urge Congress to act now, prior to the return of the hard market. And thank you very much for this opportunity to speak before you today.

[The statement and questions and answers follow:]

STATEMENT OF KARL W. KOCH, PRESIDENT, SAVERS PROPERTY AND CASUALTY INSURANCE COMPANY

I. Introduction

Good afternoon, Mr. Chairman and members of the subcommittee. I am Karl Koch, President of Savers Property and Casualty Company of Overland Park, Kansas. Savers is a three year old insurance company actively writing insurance in most states through purchasing groups established under the authority of the Risk Retention Act of 1986. We appreciate this opportunity to appear before you to relay our experiences in establishing and operating purchasing groups under the many varied interpretations of the Risk Retention act by state insurance regulators. We hope that we may add our experience to the considerations in any revisions to the Act.

II. Background

We believe the objective of Congress in passing the Risk Retention Act was to facilitate reliable insurance capacity to respond in a timely manner to those consumers who are having difficulty obtaining adequate insurance coverage at a reasonable price. This objective has been unachievable in many states however because of court and state insurance regulator interpretations of the Act. Thus we believe changes to the Act are necessary.

I have personally had the benefit of seeing the Risk Retention Act from two widely varied perspectives. I was Executive Vice President of the National Association of Insurance Commissioners (NAIC) from late 1985 to early 1988, during the period the NAIC worked with Congress in drafting the 1986 Amendments to the Risk Retention Act of 1981. In March 1988, I became President of Savers, a company which is now actively writing business nationally through purchasing groups.

Savers is located in Overland Park, Kansas and is admitted in Illinois, Kansas, and Missouri, and approved as an excess and surplus lines carrier in approximately 35 other states. Savers has capital and surplus of $11.5 million and will write $7 million in premium in 1989, most of which is from purchasing group risks. We are owned by Franklin Savings Corporation, which has assets of $13.4 billion and stockholders equity of $408 million.

Savers currently underwrites two purchasing groups; one covers individual educators professional liability and insures approximately 20,000 teachers throughout the United States. The second covers real estate appraisers professional liability and insures approximately 1,500 appraisers throughout the United States.

Both of these groups have had past difficulty obtaining professional liability coverage at reasonable costs because they share these characteristics:

(1) Small premium for each individual and for the group as a whole.

(2) "Volatility" (potential for a severe loss coupled with lack of credible premium size.)

(3) Scattered throughout the United States with a few states having only 2-10 insureds.

(4) High administrative costs to the insurer relative to premium potential in many states for (a) filing of rates and forms, (b) locating and paying "resident agents" to handle a few risks, (c) substantiating rate levels greater than admitted carriers, (d) providing evidence of declinations of risks in certain states.

Prior to enactment of the Risk Retention Act, surplus lines insurance (insurance written by carriers approved by each state but not admitted and who do not have to file rates or forms) was the only relief valve for insurance availability problems. Unfortunately, surplus lines regulations were not designed for countrywide programs writing small insureds but rather for individual risks with relatively large premiums. Most states burden surplus lines insurers with so many regulatory requirements that it is not economically feasible for the insurer to write small risks throughout the U.S. under these rules, particularly since many states will have only a handful of risks.

The regulatory requirements of a surplus lines insurer typically include:

(a) Prior approval of the insurer by the state insurance department or a surplus lines association under the auspices of the department.

(b) All business to be written through a resident of the state licensed by the state as a surplus lines broker, or countersigned by a resident agent.

(c) Each risk to present evidence of declination from admitted carriers to be eligible to be written by a surplus lines carrier.

(d) The surplus carrier having to write the risk at demonstrably greater prices than available in the admitted market.

III. Regulatory Interpretations

The Risk Retention Act intended to "cut through" this thicket of regulations. Unfortunately, many of these requirements are still applied by several states to purchasing group insurers.

We are sympathetic with state regulators and recognize their need to monitor activity of purchasing groups. Our experience is that most states perform their accountabilities in a responsive manner. A significant number however continue to create such delay and so many obstacles that we believe strengthening of the Risk Retention Act is necessary.

To illustrate these many hurdles, we have attached (Appendix 1) examples of various positions taken by state regulators.

Also attached (Appendix 2) is selected correspondence to two states illustrating the difficulties encountered in obtaining approvals.

An estimated 40 states have responded to our 1987 filings of notices to operate purchasing groups. Many of these did not respond until late 1988 after the Frontier decision in Iowa provided definition to the term "located."

A. Surplus Lines Approval

Almost all of the responding states require that the purchasing group insurer obtain approval as an excess and surplus lines insurer to write purchasing group members in their respective states.

We do not object to this requirement for approval if states respond in a timely manner to the request for approval. A few states such as Iowa and Illinois gave us approval within a few weeks. However, after eighteen months we are still exchanging phone calls and correspondence seeking approval in several states.

B. Filing and Administrative Fees

A few states have imposed filing fees on purchasing groups. If fees are not prohibited or at least restricted to moderate levels, a few states may use high fees as a "de facto" method of prohibiting operation of purchasing groups. For example, in states where the insurer may only have 2-3 insureds and a total premium of $1,000, simple economics would prohibit a $100 annual fee.

States that charge a fee include; Iowa ($100), New Mexico ($100 annually), New York ($100), Oklahoma ($400), Utah ($10), and Texas ($50). Alaska has proposed a $500 initial fee and a $200 annual continuation fee.

C. Paperwork

Another issue of great concern is the unnecessary and duplicative paperwork that many of the states impose upon a purchasing group. Some states require the very same information of the Risk Retention Act notice provision, but on their own forms and in a different order. Other states require the notice information, plus significant other information, e.g., the agent being used, the claims adjuster being used,

NAIC identification number of the insurer, federal tax identification number. Virtually all states require that the appointment of the commissioner for agent of service of process be made on their own forms.

While none of this is really difficult, some of it is clearly unnecessary. At a minimum, it is very time consuming, and can be of some considerable cost to the groups.

One form, one set of information — whatever that may be — should suffice for all the states.

IV. Modifications Recommended

We recommend that the Risk Retention Act be modified to allow a purchasing group to choose its principal place of business and that decision would trigger which state is responsible for regulating on-going operations of the insurer writing the purchasing group. All other states would be pre-empted from regulating the purchasing group and its insurer for such things as policy forms and rates but not for financial integrity.

Coupled with this however the Risk Retention Act must:

(1) Preserve the right of any state to take action if that state judges the insurer to be in hazardous financial condition.

(2) Establish minimum standards for the insurer so that purchasing

group domiciles will not congregate in the weakest links in state regulation. These requirements should include minimum capital and surplus requirements; maximum net retentions per occurrence for the insurer, and restrict writings to carriers under the jurisdiction of the U.S. judicial system and under state insurance regulation.

V. Questionable Proposals

We strongly support the working draft of proposed revisions coordinated by the U.S. Department of Commerce. However our experience dictates that a few regulators will seize on any possible ambiguity or opening to fight purchasing groups. We are quite concerned with three of the suggestions for changes that have been proposed by various sources. These proposals would defeat the intent of the Act to provide small insureds who have limited purchasing power an avenue to find reasonable cost insurance. These proposals are:

(1) Define the state regulatory authority as the state where the purchasing group "maintains an office."

Many purchasing groups do not have a formal association and do not have an office. The few states who are opposed to purchasing groups would possibly use the lack of a physical office to deny the group's authority to form. The "maintain an office" requirement would serve no valid purpose but would add ambiguity to the Act.

(2) Stipulate that the purchasing group not be established by or controlled by a insurer or person affiliated with the insurer.

Many of the purchasing groups we have seen are in fact initiated by an agent who insures several of the potential members of the group. His clients typically may not even be aware of the Risk Retention Act, until the agent takes the initiative and asks two or more members to form the purchasing group.

Any change to the Risk Retention Act should not open the possibility that states can prohibit such a method of commencing a purchasing group. Members of a purchasing group will always have the right to purchase insurance wherever they want, whether through a group or not, or to form another purchasing group with another agent or insurer.

We can support a prohibition on an insurer forming a purchasing group. Our concern however is that an independent agent could conceivably be considered "affiliated" with an insurer and some states would use that to prohibit a purchasing group from operating in their jurisdiction. We would support requiring disclosure by the agent that he is the promoter of the purchasing group.

(3) Require the purchasing group insurer to participate in risk pooling arrangements that may be set up by the various states.

This may seem equitable at first but overlooks some key points. First of all, surplus lines insurers are not now required to participate in these risk pools. If they were required to participate they would stay out of many states where participation is required. Secondly, since purchasing groups are often written for small groups of insureds with volatile exposures, the purchasing group carrier could conceivably be required to take by assignment a very high percentage of such a group, since few would be written in the voluntary market.

For example, a insurer that formed a purchasing group for asbestos removal liability risks in a state could write 50% or more of the total premiums in this line written by all insurers in the state. The state could establish a joint underwriting authority for asbestos removal liability that would require each carrier that writes such risks to participate based on its premium share. The purchasing group carrier who is solving a legitimate insurance problem in this state is now suddenly forced to accept any asbestos liability risk that state chooses to assign it, and 50% of all such risks requesting coverage, whether good or poor risks. If this were the case the purchasing group carrier would cease writing in that state.

This proposal threatens to be a fatal flaw in forming purchasing groups for many volatile classes of small insureds. If enacted it will require most insurers to go back to a pure surplus lines approach and consumers will lose the benefits intended by the Risk Retention Act.

We believe that many of the proposals which would make purchasing group operations more difficult were spawned in the first several months after the Act was passed. During this time, a few questionable insurers filed notices of intent on a blanket basis to operate many purchasing groups. These filings of course caused concern that questionable carriers would take advantage of the Risk Retention Act exemption to state regulations. We believe that this increase in activity by questionable insurers has moderated and we should not change the Risk Retention Act to address a problem that no longer exists.

Secondly, questionable insurers in various states were operating long before the Risk Retention Act. The Risk Retention Act can no more completely prevent questionable insurers operating than could the combined effect of fifty state insurance laws and regulations over the last one hundred years. All that can be asked is that the Risk Retention Act not provide a haven for non-legitimate insurers and we believe no evidence exists that it has provided such a haven.

VI. Conclusion

The Risk Retention Act endeavored to carve narrow exemptions to state regulations to make liability insurance more readily available to consumers, yet balance the exemptions with sufficient tools for state regulators to continue to protect their insurance consumers. The Act has substantially met its goals and requires only minor modifications to resolve the ambiguities that have evolved in state regulator's interpretations.

We urge that the Committee proceed cautiously in its considerations and make only those changes that will aid smaller insureds with difficult liability exposures to find insurance from acceptable insurers.

We believe these changes are:

(1) Establish minimum financial standards for purchasing group insurers.

(2) Establish only the state of the purchasing groups domicile as the appropriate authority for administration of insurer approval, rate and form approval, agent licensing, and other operational concerns. All other states should be pre-empted from exerting such authority.

(3) Authorize any state to take action against the insurer of a purchasing group if that state determines the purchasing group insurer to be in a hazardous financial condition.

(4) Establish one form of notice with adequate information for all the states, and allow the states the option of charging a fee for filing, not to exceed $25.00

We urge Congress not to be put off by the current soft market and easy availability of insurance at attractive rates. The same signs exist today that existed in 1983 and 1984 shortly before the hard market suddenly returned. We believe that a return to a difficult market is inevitable and that a properly constructed Risk Retention Act will substantially

99-266 - 89 - 7

aid making coverage available during that time. We appreciate the opportunity to appear before you today, and will be happy to answer any questions you may have. Thank you.

Dear Senator Bryan:

Thank you for the opportunity to respond to further questions concerning the Risk Retention Act. Our comments are as follows:

Q: Your testimony describes some of the difficulties that your members were confronting which made formation of a purchasing group attractive. In your opinion, which were the greatest motivating factors for the teachers and real estate appraisers?

A: The real estate appraisers sought an insurer to replace one that had quit writing appraisers entirely. Insurers interested in writing appraisers were very limited. The "purchasing group" route in 1987 allowed Savers to quickly provide a market since we did not have to incur the delay or expense of (1) obtaining approval as a surplus lines carrier in each state; (2) did not have to file forms and rates in each state; and (3) did have to find a resident agent in each state. If we did not have the advantages of the Risk Retention Act, we estimate it would have taken us at least 6-12 months lead time to furnish the group coverage.

It should be noted that since 1987 and the Frontier decision in Iowa, many states have taken positions that would no longer allow an insured the benefits enumerated in items (1)-(3) in the preceding paragraph.

The school teachers group likewise sought coverage and form flexibility not available in the traditional market.

Q: Based on your experience, would you recommend to other groups that they utilize the act? Do the benefits outweigh the burdens?

A: The Risk Retention Act (RRA) inherently recognizes key weaknesses of state regulation: (1) duplication of requirements for insurers; (2) unevenness - certain states are strong regulators while others are weak; (3) protectionism of resident agents and (4) bureaucracy - the tendency to expand responsibilities without reason or justification.

Any group of insureds who need an insurer who can provide pricing and coverage specifically tailored to the needs of the group members is well advised to utilize the RRA since it provides an avenue to avoid these regulatory weaknesses.

As to "burdens": Caution is recommended in evaluating comments or modifications of the RRA proposed by the National Association of Insurance Commissioners (NAIC). The NAIC only speaks the "consensus" of its members and its model bills in like fashion reflect only consensus. individual state members frequently deviate greatly from NAIC positions.

Our experience is that the NAIC position is usually well-balanced. However the individual state regulators and legislators do not uniformly follow the NAIC position. Even though thirty-three (33) states have enacted the NAIC model RRA bill, many significantly modified it legislatively or by regulation and further, after implementation, interpreted the law in ways not consistent with the NAIC position.

Q: You refer to filing fees required by the states. Do these fees discourage the formation of groups? In your opinion, is that why they are imposed?

Small fees, e.g. $25, for an initial notice filing would not discourage the formation of groups. On the other hand, the cost to the state for collecting and accounting would probably exceed $25. Larger fees would discourage groups, particulary in certain states, and thus cost consumers in those states the benefit of the RRA.

For example, in a populous state such as New York or California, a larger fee is no problem since the number of insureds (and premium) in the state will bear the cost. However many states (such as Wyoming, Utah, Kansas, etc) will only have a few insureds - in these states the insurer may well choose not to provide insurance if a large fee were imposed.

We believe that the very few states imposing high fees do so to discourage purchasing groups.

Q: What kind of information should a state have to ensure that a purchasing group insurer is financially sound?

A: Each state in which purchasing group members reside should receive a copy of the insurer's annual convention statement.

Each state should utilize this report to ascertain that the insurer meets minimum financial standards. Recommendations for these were made in my written testimony.

Submission of the annual statement is now required by all states in which premium is written. However the "location" argument may confuse the issue as to whether purchasing group insurers are required to furnish their annual statement on the basis of members residence or the purchasing groups domicile. The filing requirement should be based on member's residence.

No other routine financial information should be required. States now perform their regulatory responsibilities for admitted and approved surplus lines carriers utilizing only the annual statement for an information source on financial performance.

Additionally, the same biographical affidavits of officers and directors now required by the states for admission or surplus lines approval should be required to be submitted with the initial notice to states of the purchasing group. This will give regulators the track records of insurer management. (A sample copy of this affidavit is enclosed.) To prevent individual states from each designing their own form, causing duplication, the Risk Retention Act should specify that only the NAIC form can be used.

Q: It has been suggested that purchasing groups not be established by an insurer or controlled by a person affiliated with an insurer. You reject this alternative, because agents often suggest the creation of a group. Instead, you say that agents should disclose their relationship to the purchasing group. Is disclosure sufficient?

A: Disclosure should be sufficient and should be submitted to regulators as part of the initial notice of the purchasing groups to states. Thus the states would be able to identify who "promoted" the group.

Further disclosure would only serve as an unneeded obstacle to purchasing group formation.

Sincerely yours,

Karl W. Koch
President

KK:ss

Senator BRYAN. Thank you very much, Mr. Koch.
Mr. Salisbury.

STATEMENT OF JOHN SALISBURY, ON BEHALF OF THE PUBLIC RISK MANAGEMENT ASSOCIATION

Mr. SALISBURY. My name is John Salisbury. I am employed as the full-time Chief Executive of the Housing Authority Risk Retention Group, and I am testifying today on behalf of the Public Risk Management Association, its acronym PRIMA. It is a professional association for public risk managers, and collectively its professional and its intergovernmental risk pooling members serve more than 7,000 public entities in the U.S.

In the brief time I have, I would like to primarily focus on two points from the written testimony. These points are:

First, the Liability Risk Retention Act meets an important need of public entities;

And second, we are urging Congress not to adopt any change in the Risk Retention Act that would permit states to prohibit public entity participation.

I should say that public sector intrastate risk sharing has grown significantly over the past 16 years and has been very successful. It has evolved for a series of reasons. Foremost has been the lack of coverage or the high cost of insurance.

I should, however, emphasize that intrastate risk sharing is not always a viable alternative, particularly in situations where the number of public entities providing similar services within a state do not have a sufficient spread of risk. For example, not enough housing authorities or airports exist within most states to provide a sufficient spread of risk.

To date there are three public sector risk retention groups: Housing Authority Risk Retention Group, Inc., States Self-Insurers Risk Retention Group, Inc., and the American Airport Executive Risk Retention Group.

In the future, PRIMA feels it is possible that public entities will join together under the Risk Retention Act to share in specialized liability coverages for exposures such as fuel storage tanks, solid waste disposal, lead-based paint, other pollution coverages, and to higher limit excess coverage. For these reasons, PRIMA continues to support the Act.

PRIMA is, however, very concerned over past and present attempts to single out public entities from other groups and to prevent them from being beneficiaries of the Risk Retention Act. The National Association of Insurance Commissioners seems to assert in their model draft that the Act should permit state prohibition.

In the 1987 session of the New York Legislature, after the Risk Retention Act was enacted by Congress, a similar proposal from the state insurance department was rejected. In fact, the Housing Authority Risk Retention Group, which was already providing coverage to several large public housing authorities in New York, found no alternative but to lobby against such action.

Federal preemption of the legal theory that public entities are the sole creatures of a state is not without precedent. Examples are Federal statutes and minimum standards that preempted lesser or

nonexistent state standards in such areas as minimum wages, employment practices, the environment, et cetera.

The fact is the vast majority of states, I think the number is 47, already permit some form of public entity risk sharing. In general, most states have chosen not to regulate intrastate public risk sharing, nor have they imposed the capital, surplus, and other reporting requirements which risk retention groups or other insurers must comply with.

For a state to prohibit public entity participation in a risk retention group in such circumstances would be discriminatory. One example of such discriminatory actions is currently occurring in New Jersey, which is asserting that public entities in New Jersey cannot become members of the States Self-Insurers Risk Retention Group. This occurred after the New Jersey Legislature failed to pass legislation prohibiting public entities from participating in risk retention groups.

I would like to make one additional point on the issue of prohibiting public entity participation. A practical and indirect effect of such a prohibition will be to encourage public entities to select a less desirable alternative, a traditional insurance captive with a commercial insurer that serves as a fronting carrier.

The effect will be to increase the cost of insurance to interested public agencies and possibly make the captive less financially viable. We are already aware of at least two public sector captives that cannot utilize the Risk Retention Act because they provide lines of coverage not permitted under the Act.

The written testimony that we have submitted also commends Congress for creating a simplified structure for regulating the formation and operation of risk retention groups. However, we regret to report that selected non-charter states have raised barriers to the operation of risk retention groups, contrary to the intent of Congress. An overview of the problems in selected states include:

One, state rejection of straightforward registration process, creating added paperwork and certainly challenging the state preemption provided by the Act;

Second, registration fees and non-admitted tax rates that discourage the operation of risk retention groups and at best stretch the limits of the intention of the Act;

Finally, state prohibition of direct writing through the requirement of a licensed agent or broker.

Specific examples of these problems are contained in the written statement. In addition, I have submitted a rather extensive exhibit of specific correspondence with various state insurance departments as they relate to the Housing Authority Risk Retention Group.

In summary, PRIMA believes that the Liability Risk Retention Act meets an important need of public entities. The problems public entity risk retention groups have identified in the implementation of the Act do not require major changes in the legislation.

We are confident your oversight hearings will point out similar concerns of other types of risk retention groups. We ask that any future proposed amendments to the Act that would restrict public entity participation in risk retention groups be rejected.

We urge Congress to continue the simplified structure of regulation under the Act and clarify the degree of non-charter state preemption approved by the Act.

Thank you, Mr. Chairman.

[The statement and questions and answers follow:]

STATEMENT OF
JOHN SALISBURY
ON BEHALF OF THE
PUBLIC RISK MANAGEMENT ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON THE CONSUMER
SENATE COMMERCE, SCIENCE AND TRANSPORTATION COMMITTEE
HOLDING HEARINGS ON
THE LIABILITY RISK RETENTION ACT AMENDMENTS OF 1986
MAY 3, 1989

Mr. Chairman and Members of the Committee:

My name is John Salisbury. I am employed as the full-time chief executive of the Housing Authority Risk Retention Group, Inc. I am testifying today on behalf of the Public Risk Management Association (PRIMA). PRIMA is the professional association for public risk managers. PRIMA's membership is made up of more than 1,400 public agencies nationwide and in Canada, including cities, counties, towns, school districts, and other general and special-purpose governments. The membership also includes more than 70 intergovernmental risk-sharing pools. Collectively, PRIMA represents more than 7,000 public agencies. PRIMA's member representatives oversee all aspects of public agency risk management, which includes direct responsibility for evaluating and administering risk financing programs.

In the early 1980s, the United States was in the midst of an insurance crisis. Liability coverage was either severely limited or simply non-existent. To exacerbate the problem, the cost of this coverage, even when it was available, had increased dramatically and without warning. The nation's cities, counties,

school districts and other branches of government, because of their unique responsibilities, were especially vulnerable. Consequently, the ability of public agencies to deliver the services required of them by the public was endangered.

In order to meet their responsibilities and protect the public, it became incumbent upon local governments and other public entities to go outside the traditional insurance market to seek alternative ways to finance risk. Public entities needed a risk retention law which protected the public welfare while maintaining sufficient ease of implementation to allow efficient creation of these groups. The passage of the Liability Risk Retention Act Amendments of 1986 provided a viable alternative mechanism to the traditional insurance market.

Risk-sharing among public entities is not something new. More than 200 intrastate public sector risk pools have evolved over the past 16 years. In fact, PRIMA's Pooling Section has over 80 intergovernmental self-insurance pools as members, including pools established by state municipal leagues, school boards, county associations, regional arrangements, joint power authorities, and other interlocal agreements. These pools provide a variety of coverages -- workers' compensation, property/liability, employee benefits, unemployment compensation, etc. Pools are offering their members a viable risk financing alternative and, in the long run, independence from the ups and downs of the insurance market. The development of public entity

risk-sharing pools has also increased because of demonstrated long-term cost savings, greater control over risk financing and development of improved risk management practices.

We should emphasize, however, that pooling is not always a viable alternative, particularly in situations where the number of public entities providing similar services within a state is not sufficient to provide an adequate spread of risk. For example, not enough housing authorities or airports exist within most states to provide a sufficient spread of risk for pooling purposes.

Even though public sector intrastate pooling has been very successful, these pools may need special or higher coverage limits that were historically provided by the excess insurance market. When this market all but disappeared during the insurance crisis, public agencies were forced to look elsewhere in an effort to reach those higher limits. Risk retention groups could substitute for this disappearing market by allowing public agencies to cross state lines and create the potential for covering catastrophic losses.

To date, three public sector risk retention groups have been created:

- Housing Authority Risk Retention Group, Inc., which provides liability insurance to public housing and redevelopment agencies. Vermont domicile. Started operation June 1, 1987.

- o States Self-Insurers Risk Retention Group, Inc., which provides excess liability coverage to self-insured public entities or public entity pools. Georgia domicile. Started operation July 1, 1988.

- o American Airport Executive Risk Retention Group, Inc., which will provide liability coverage to public airports. Currently seeking surplus contribution commitments. Expects to be operational in late 1989.

In the future, it is possible that public entities will join together under the Liability Risk Retention Act to share specialized liability coverages for exposures such as fuel storage tanks, solid waste disposal, lead-based paint or other pollution exposures. The need for higher limit excess coverage for large public entities that self-insure or for public entity pools may be a future use of the Act. For these reasons, PRIMA continues to support the risk financing alternative provided by the Liability Risk Retention Act.

STATE REGULATION

Congress is to be commended for creating a simplified structure for the formation and regulation of risk retention groups. The concept of having the chartering state regulate the formation and operation of the risk retention group is a sound one. The three public entity risk retention groups have each reported that their domiciliary states are performing effective review and active oversight of their activities. However, we regret to report that public entity risk retention groups have experienced situations where a state, other than the group's

state of domicile, has raised barriers contrary to the intent of Congress.

We are very concerned over past and present attempts to single out public entities from other groups as to whether or not they can use the Liability Risk Retention Act. We feel such efforts are against the intent of Congress.

For example, the drafting note which follows Section 2F(b) in the National Association of Insurance Commissioners (NAIC) Model Risk Retention Act (July 1987) seems to assert that state legislatures have the absolute authority to preclude public entity participation in risk retention groups:

> "A state may specify acceptable means for managing the liability of the state or its local governments, or any agency or political subdivision thereof, by including or excluding insurance coverage obtained from an admitted insurance company, an excess lines company, a risk retention group, or any other source; or through a broker, agent, purchasing group, or any other person."

A 1987 statute proposed in New York unsuccessfully attempted to do this, in spite of the fact that Section 3902(a)(4) of the Liability Risk Retention Act (non-discrimination sections) preclude such legislation. The Housing Authority Risk Retention Group, Inc., which was already providing coverage to several large public housing authorities in that state, had to expend its limited resources to lobby against such action.

We are also concerned with particular language contained in discussion draft amendments to the Act now in circulation. This language is identical to that included in the U.S. Department of

Commerce "Implementation Report" of September 1987 on the Liability Risk Retention Act of 1986 and states:

> "Any law, rule or regulation which would make unlawful the forming or joining of a risk retention group or a purchasing group by a state or any local government or agency or political subdivision thereof is pre-empted by this chapter in the absence of state legislation expressly prohibiting such forming or joining."

This amendment, like the NAIC Model Act language, would permit states to prohibit public entity participation in risk retention groups. It is imperative that there be no restrictions or inappropriate barriers set up to prohibit the use of risk retention groups by political subdivisions of a state.

Federal pre-emption of the legal theory that public entities are the sole creatures of a state is not without precedent. Federal statutes and minimum standards that pre-empted lesser or non-existent state standards in such areas as minimum wage, employment practices, the environment, etc., are examples. Our premise is that local governments and public agencies must not be held hostage by an unpredictable insurance market. The insurance crisis may have diminished, but it has not disappeared.

Another problem exists because the fairly straightforward approach for filing and reporting in the various states under the Liability Risk Retention Act is being rejected by a number of non-domiciliary states. The result is added paperwork and reporting requirements. To a certain extent, we believe that the NAIC Model has contributed to the enactment of legislation or regulations that have resulted in states attempting to over-

regulate. For example, the Act requires each risk retention group to submit for approval, in the state where it is chartered, a plan of operation or feasibility study that includes certain items as specified in the Act. The Act then states, in plain language, that "a copy of such plan or study (which shall include the name of the state in which it is chartered and its principal place of business:..." be filed with each non-domiciliary state in which it intends to do business:

> "...a plan of operation or a feasibility study which includes the coverages, deductibles, coverage limits, rates, and rating classification systems for each line of insurance the group intends to offer." (15 USC Section 3902(d)(1)(A))

The NAIC Model Risk Retention Act Section 2H (July 1987) expands the Liability Risk Retention Act's definition of plan of operation or feasibility study:

> "H. 'Plan of operation or a feasibility study' means an analysis which presents the expected activities and results of a risk retention group including, at a minimum;
>
> (1) information sufficient to verify that its members are engaged in businesses or activities similar or related with respect to the liability to which such members are exposed by virtue of any related, similar or common business, trade, product, services, premises or operations;
>
> (2) for each state in which it intends to operate, the coverages, deductibles, coverage limits, rates, and rating classification systems for each line of insurance the group intends to offer;

(3) historical and expected loss experience of the proposed members and national experience of similar exposures to the extent that this experience is reasonably available;

(4) pro forma financial statements and projections;

(5) appropriate opinions by a qualified, independent casualty actuary, including a determination of minimum premium or participation levels required to commence operations and to prevent a hazardous financial condition;

(6) identification of management, underwriting and claims procedures, marketing methods, managerial oversight methods, investment policies and reinsurance agreements;

(7) identification of each state in which the risk retention group has obtained, or sought to obtain, a charter and license, and a description of its status in each such state; and

(8) such other matters as may be prescribed by the commissioner of the state in which the risk retention group is chartered for liability insurance companies authorized by the insurance laws of that state."

In many instances, the plan of operation, which must be submitted to non-domiciliary states, contains information not required in the chartering state's plan of operation. In other instances, non-domiciliary states require that their extensive application forms be completed. This often requires the risk retention group to reformat information already contained in the original plan of operation. Hence, there is added paperwork, additional information requests and the view that each state must approve the operation of any risk retention group desiring to

write business in that state. Lost in the process is the simplicity of the registration process that was the intent of the Liability Risk Retention Act.

As the chief executive of the Housing Authority Risk Retention Group, Inc., I can tell you that challenging non-domiciliary regulatory action has already become costly and time-consuming. It goes beyond what I feel was anticipated by those who authored the legislation. Our primary focus is to provide insurance and quality services to public housing authorities. A regulatory environment that might be characterized as "regulation by intimidation" continues in certain states. Unfortunately, many choose the short-term, easy, and less expensive route instead of challenging the states by testing the state pre-emption provided by the Liability Risk Retention Act. The threat of enforcement due to failure to comply with a particular state's divergent "registration procedures" may also contribute to a chilling effect on the formation of other risk retention groups.

REGISTRATION FEES AND PREMIUM TAXES

Another problem public entity risk retention groups have experienced is state discouragement of operation of risk retention groups through registration fees and taxation. One state, New Hampshire, has gone so far as to impose not only a registration fee but also a minimum tax regardless of whether a risk retention group is writing coverage in the state. Others

have imposed or are in the process of imposing registration fees. Alaska and California are proposing $1,000 and $2,500 fees, respectively. Another subtle method of making it more difficult to operate and compete in a given state is to tax risk retention groups at the higher rates of non-admitted or surplus line carriers rather than at the lower rates charged foreign admitted insurers. The collective registration fees in themselves can be a substantial burden on a risk retention group that is starting operations. Additional revenues, rather than well-managed, solvent risk retention groups appear to be a primary motive.

DIRECT WRITING

Selected states, such as Wisconsin, have attempted to assert that a risk retention group cannot be a direct writer of insurance. In other words, the group must use the services of an agent or broker licensed in the state of the policyholder. It is our understanding that the Act did not mandate or require use of an agent or broker. Generally, the Board of Directors and salaried employees of insurance companies are not subject to each state's licensing requirements. Risk retention groups should have the option of being either direct writers or using licensed agents or brokers. This is the case with state public entity pool enabling legislation.

CONCLUSION

In summary, PRIMA believes that the Liability Risk Retention Act meets an important need of public entities. The problems public entity risk retention groups have identified in the implementation of the Act do not require major changes in the legislation. We are confident your oversight hearings will point out similar concerns from other types of risk retention groups. We ask that any future proposed amendments to the Act that would restrict public entity participation in risk retention groups be rejected. We urge Congress to continue the simplified structure of regulation under the Act and clarify the degree of non-domiciliary state pre-emption provided in the Act.

Thank you for this opportunity to present our views. We will provide the committee with a short profile of the Housing Authority Risk Retention Group (HARRG) and a series of exhibits which represent a sampling of HARRG's communication with various state insurance departments.

I would be glad to respond to questions from the committee or future inquiries from your staff.

Dear Senator Bryan:

I appreciated the opportunity to testify on behalf of the Public Risk Management Association (PRIMA) at the Consumer Subcommittee hearing on the Risk Retention Act. Outlined below are PRIMA's responses to the additional questions you have posed.

1. QUESTION

Having just recently come from state government, I am sympathetic to the problems that public entities experience in obtaining liability coverage. As you point out, this can affect their ability to provide services to the public. Can you provide specific examples of the kind of problems that public agencies were confronting, and the effects of the situation?

RESPONSE

Since I am currently the Executive Director of Housing Authority Risk Retention Group (HARRG), I will begin by discussing the problems public housing authorities faced during the liability insurance crisis.

During the height of the crisis, many public housing authorities were either unable to obtain liability coverage or unable to obtain liability coverage at reasonable rates. A consultant study completed in October 1986 for the Council of Large Public Housing Authorities illustrates the magnitude of the insurance availability problem. Forty-three public housing authorities were surveyed. These authorities represented over 480,000 housing units and 37% of the total units in the United States.

The survey revealed that 24% of the authorities did not have any general liability coverage. A startling 84% of the public housing authorities did not have excess liability coverage.

Although public housing authorities are required by contract to obtain insurance coverage through a competitive bidding process, over 120 authorities applied to HUD for waiver of the requirement. These authorities either received no responses to their bids or received responses which were too costly.

Studies were also conducted regarding the issue of affordability of liability insurance. The Department of Housing and Urban Development's November 14, 1985 "Insurance Survey Standard Report" revealed that between 1982 and 1985 there was a 290% increase in general liability insurance rates. The study conducted for the Council of Large Public Housing Authorities revealed that between 1983 and 1987 some authorities experienced as much as 489% increases in liability insurance rates.

The insurance premium increases had a significant impact on housing authority operations. HUD stated that:

> ...These increases have had a significant impact on the ability of [public housing authorities] to maintain solvency of their public housing programs while carrying adequate levels of insurance coverage. **

** Department of Housing and Urban Development " Insurance Survey Standard Report" (November 14, 1985).

3

A housing authority's rental income is largely controlled by statute. Increased insurance costs could not be offset by increases in rent. As a result, many housing authorities were forced to reduce expenditures in other areas. These areas included maintenance, security and repair. Ironically, these areas are also crucial to reducing the costs of insurance. Increased insurance premiums resulted in a reduction of funds available to provide safe, decent and sanitary housing for low income persons.

Other public entities experienced difficulties similar to housing authorities. Local and state governments were threatened by a liability crisis unmatched in recent history. Liability insurance for municipalities was practically unavailable at any price, or at prices that were unaffordable.

Small local governments closed up shop and disincorporated because commercial insurance was unobtainable to protect the community and its officials from law suits. Mayors and councils resigned. Police patrols were pulled off the streets. School busses sat in the school yard. Parks and playgrounds were shut down. All because insurance was not available, or was cancelled or not renewed, or too expensive.

PRIMA surveyed it members in 1985 and again in 1986 to determine the status of their ability to obtain affordable insurance. As you will see from the attached reports **** on the finding of those surveys, for the 1986 renewal period for comprehensive general liability insurance, respondents showed an average policy increase ranging from 10% to 354%. For the 1985 renewal period, the increase ranged from 10 % to 2,200 % .

**** "Local Governments at Risk: The Crisis in Liability Insurance" ("The Municipal Year Book" 1987)

" PRIMA Reports on Insurer and Municipality Survey" (October 1986)

"PRIMA Surveys Reveals Insur. Crisis Nationwide" (November 1985)

2. QUESTION

You assert that states other than the state of domicile have raised barriers to public entity risk retention groups. What kinds of barriers have been created? How easily have they been overcome, if at all?

RESPONSE

Several barriers which tend to discourage the operation of public entity risk retention groups have been raised. These barriers include state attempts to prohibit public entities from participating in risk retention groups, state adoption of cumbersome registration procedures and the imposition of registration fees. In addition, some states have imposed higher tax rates for risk retention groups and have required the use of licensed agents.

PUBLIC ENTITY PARTICIPATION

Without question, state attempts to prohibit public entities from participating in risk retention groups is the greatest concern of public entity risk retention groups. As discussed during the hearing, the National Association of Insurance Commissioners (NAIC) Model Risk Retention Act suggests that states have absolute authority to prohibit public entities from participating in risk retention groups.

The New York Insurance Department urged its state legislature to prohibit public entity participation. At the time, Housing Authority Risk Retention Group (HARRG) was the only public entity risk retention group operating in New York. Although HARRG was able to overcome this barrier, it was not easy. HARRG and its members had to expend significant funds to lobby against such action. Staff efforts also had to be redirected from the primary mission of managing a much needed insurance program. Now, New Jersey is considering a similar proposal to prohibit public entity participation.

REGISTRATION PROCEDURES

State registration procedures have created a barrier for all risk retention groups. Most states have developed their own unique registration forms. Completing these forms is often a time-consuming task. This is particularly frustrating when the forms request information already supplied to the state in the risk retention group's plan of operation.

In addition, certain states have attempted to use the registration process to circumvent the intent of the Act. These states have attempted to use the registration process to conduct in-depth review and approval of the group. We believe the Act was designed to streamline regulatory procedures. The Act envisions approval and strict regulation of the group by one state. The group would then register its intent to do business in the remaining states. Adoption of a uniform registration procedure would reduce this barrier.

REGISTRATION FEES

Varying registration fees imposed by states have created another barrier for risk retention groups. Certain states require cost prohibitive fees. Others have taken the position that the group must pay a registration fee although the group is not actually writing insurance in the state. Payment of fees in states where the group is not doing business or where the number of insureds is limited prohibits the group from operating in those states.

TAX RATES

Insurance companies are taxed on the amount of premiums written in a given state. Many states have chosen to treat risk retention groups as non-admitted or surplus lines insurance companies. This treatment results in risk retention groups paying higher taxes than traditional insurance companies. Higher tax rates combined with registration fees can be important factors in the business decision of whether to write insurance in a given state.

USE OF AGENTS

Many traditional insurance companies write insurance directly without the use of agents. Some states have indicated that risk retention groups are not permitted to write insurance without the use of state licensed agents. For the most part, this issue has been resolved for Housing Authority Risk Retention Group. The majority of states now permit direct writing. There are a few states which refuse to permit direct writing. It would be helpful if this issue were clarified.

3. QUESTION
Your testimony refers to recommendations of the Department of Commerce and NAIC regarding participation by public entities in risk retention groups. It appears that you want the Congress to preempt any express state law that would prohibit public entities from forming these groups. Is that correct? If so, why?

RESPONSE
We believe the Liability Risk Retention Act of 1986 already preempts state law that would prohibit public entities from forming these groups. The legislative history of the 1986 Act supports that conclusion.

The 1986 Amendments were adopted in response to the crisis in availability and affordability of commercial liability insurance. Congress found that municipalities were among the groups seriously affected by the crisis. H.R. Rep. No. 865, 99th Cong. 2d sess. 7 (1986).

In the course of the Senate discussion of the amendments, one of the bill's original co-sponsors gave particular emphasis to the need for providing an alternative means of obtaining liability insurance for local governments. Senator Rockefeller used the example of a local government's inability to obtain liability insurance as an illustration of the critical need for congressional alleviation of the problem. 132 CONG. REC. S9235-36 (daily ed. July 17, 1986). He further explained that the amendments to the Act give municipalities, among others, "the option of forming insurance pools on a nationwide basis." Id. at S9236.

The Federal preemption is justified for several reasons. First, few states currently restrict public entities from procuring insurance from non-admitted insurance companies. In fact, much of the public official, law enforcement, and excess liability coverage of public entities has been procured from these markets. Risk retention groups, which many states are treating as non-admitted carriers, should also be permitted to provide the coverage.

Second, most states currently permit intrastate public entity pooling. In most cases, participation in interstate pooling mechanisms or risk retention groups should provide states with greater security. First, participation in risk retention groups increases the predictability of losses for many types of risks due to the increased spread of risk. Additionally, risk retention groups (unlike many pools) are regulated by chartering states and must meet certain capital and other requirements.

Another practical consideration is the burden that would be placed on public entities currently participating in or seeking coverage from a public entity risk retention group. Unnecessary public funds and staff time will be expended to prevent state legislative action. It will divert public entity and risk retention group resources from their risk management and insurance service priorities.

Congress is the legislative body that can most easily act on the need for interstate public entity risk sharing. We do not see the need to reopen that debate in each and every state legislature. There is precedent for Congressional preemption of state action in many other areas i.e. minimum wage, environment, etc.

There is a high probability that a state which charters a public entity risk retention group will have public entities within the state who wish to participate in risk retention groups. This realization assures that a sound plan of operation will be needed to secure necessary approval of the group.

Federal funding is involved in many public entity programs. This is certainly the case for public entities that currently participate in the risk retention groups. The availability and long term savings which result from public entity participation in risk retention groups benefit the programs that Congress funds.

There should not be a double standard that allows a business to secure insurance from a risk retention group and does not allow a public entity to secure the insurance coverage. In both instances the key is whether the charter state performs its regulatory responsibilities in a manner that assures the financial solvency of the risk retention group.

Although we recognize that charter states have differing capital, surplus and other regulatory requirements for risk retention groups we believe charter states are taking their regulatory responsibilities seriously. What needs to be built is a greater degree of trust between state regulatory agencies.

4. QUESTION
You identify several instances of excessive paperwork requirements by states. Your testimony seems to suggest that states require additional information of groups, or utilize inconsistent forms, in order to intimidate applicants and discourage the formation of groups. Is that accurate?

RESPONSE
Yes. We provided the Committee with specific documentation of forms and other correspondence Housing Authority Risk Retention Group, Inc. has had with selected states. As members of the Consumer Subcommittee realize, the National Association of Insurance Commissioners opposed the 1986 Risk Retention Act. We believe the Congressional intent of the Act has not been carried out largely because selected insurance departments do not agree with the policy of state preemption that was adopted by the Act.

Attached to this response is the most recent example of excessive paperwork required by states. In this instance the Texas Insurance Department would not accept a photo copy of the Housing Authority Risk Retention Group's license. The Risk Retention Act does not even require that this document be provided. We provided it out of courtesy. Subsequently, we were informed that the photocopy was not acceptable. Can you imagine the State of Vermont having to issue 50 original licenses for each of the risk retention groups it charters. Instances of unnecessary and, in some cases, duplicative paperwork are numerous.

5. QUESTION
Your testimony maintains that agents should not be required for risk retention groups. Without such a requirement, will a state be able to oversee the formation of the group and ensure that the policyholders are protected?

RESPONSE
States currently permit admitted insurance companies to be direct writers and not use licensed insurance agents. An example of the regulatory policy of the state of Connecticut is enclosed. The Risk Retention Act does not currently require the use of agents.

The policyholders of a risk retention group are protected in several respects. First, the risk retention group must comply with the unfair claim settlement practices law of the state where the insured is located. These state statutes permit the respective insurance departments to protect the interests of both the policy holder and the claimant(s). In addition, risk retention groups must comply with state laws regarding deceptive, false or fraudulent acts or practices. In short, policyholders have significant recourse through state insurance departments and courts.

Second, the Liability Risk Retention Act requires a risk retention group to submit to an examination by any State insurance department if the state in which the risk retention group is chartered has not begun or refuses to initiate an examination. Risk retention groups must provide the states in which they operate copies of the charter states examinations. If they are determined to be in hazardous financial condition, a risk retention group's activities can be enjoined.

Further protection is provided by the requirement of an annual financial statement certified by an independent public accountant and an annual actuarial loss reserve certification by a qualified actuary. Some states do not have similar requirements for the insurers they regulate.

Moreover, only the owners of a risk retention group provided insurance. They also control the company. These factors insure that policyholders have a say in selecting the governance of the organization. They are also involved in the proper operation of the risk retention group program.

Congress has taken significant action to protect the policyholder under the Act. The policyholder has protection whether or not there is an agent.

If we may be of further assistance, please do not hesitate to call.

Sincerely,

John Salisbury
Executive Director
HARRG

Senator BRYAN. Thank you very much, Mr. Salisbury.

We have been notified that we have a vote in seven and a half minutes. So let me just pose one or two questions and yield to my colleague, Senator Kasten, for a couple of questions, and then we are not going to be able to ask this panel all of our questions, unfortunately. But we will handle those in writing.

I want to focus in on the requirement of an independent agent or a licensed agent of some kind. Mr. Koch, you wear two hats, in effect. You formerly came out of a regulatory climate, now you are involved in a purchasing group operation.

Is it unreasonable to expect that there be somebody to be licensed under the auspices of a state who in effect is selling a product that the public will understand to be insurance, even though one can make a technical distinction that it is not, but someone who is responsible for the representations, the promises, the commitments, the quality of the product?

Should not the state be able to look to someone to uphold the standard of integrity that licensing laws try to ensure, at least at a minimum?

Mr. KOCH. We operate exclusively through agents, so our judgment obviously is skewed toward the independent agent system. But I am reminded that there are many companies who operate on a direct basis, very large personal lines carriers operating on a direct basis, successfully and with a great deal of integrity.

And if the state should be required, relating to purchasing groups, to accept non-resident agents, then they already lose the benefit of the control of the agent as a resident.

Personally, I believe that direct mail or direct marketing should be an authorized way to operate. I see no reason to penalize purchasing group insurers and force them into an agent distribution system.

Senator BRYAN. You felt that way as a regulator? Can not one make an argument that, however the product is marketed, somebody ought to have some responsibility under the state system for the quality of the representations, the knowledge of the product? Granted that the licensing law does not guarantee a person of integrity, but it has at least some minimal threshold requirement.

Mr. KOCH. Well, it is an excellent point, although I would think that the individual state insurance department should have access to the insurance company if they are doing the marketing directly, without an agent. They should have recourse then direct to the company.

Senator BRYAN. Senator Kasten, I know you probably have some questions. Let me yield my time to you in light of the fact that we are going to have to leave very shortly.

Senator KASTEN. I am not going to ask a question. I just want to, with regard to Mr. Salisbury's point, I just want to put in the record a statement which I made in the Congressional Record in July of 1986. I said:

"These amendments expand the definition of those eligible to form risk retention groups under the Act to include businesses, professionals, hospitals, schools, churches, or other institutions, and state and local government entities."

That was the statement and that was what was intended by the legislation. And I was just fortunate that one of our staff people provided me with it.

But the point I would like to make, Mr. Chairman, is I think that we could go back, on a number of the questions that have been raised by a number of the panelists, and determine what we intended. And this was an effort that was made by Republicans and Democrats, by the leadership on this committee and on this subcommittee.

It demonstrates that what we intended is not being carried out. It also shows how important this hearing has been today, with the excellent group of witnesses, that you have assembled, Mr. Chairman, and I think that we now can work together and deal with some of these questions and problems.

I thank you.

Senator BRYAN. Senator Kasten, thank you very much for your interest and your question and observation.

I thank each member of the last panel and all who appeared today, either as witnesses or those who are interested observers. We will get back together with you.

This subcommittee hearing is adjourned and we are in recess.

[Whereupon, at 4:18 p.m., the subcommittee was adjourned.]

Victor O.
Schinnerer
& Company, Inc.
Two Wisconsin Circle, Chevy Chase, Maryland 20815-7003 • 301/961-9800 • Fax 301/951-5444 • Telex 261829

Douglas C. Dolan, Jr.
Senior Vice President

April 28, 1989

Mr. Kevin Curtin, Majority Counsel
Consumer Subcommittee
Committee on Commerce, Science and Transportation
United States Senate
227 Hart Senate Office Building
Washington, DC 20510

Dear Mr. Curtin:

We are pleased that the Senate Committee on Commerce, Science and Transportation is holding oversight hearings and considering various amendments to clarify the Liability Risk Retention Act of 1986.

Victor O. Schinnerer & Company, Inc. is the country's oldest and largest underwriting manager and program administrator for professional liability and specialty casualty insurance programs. Our clients include five risk retention groups. Based on our experience with the Act, we assure you that clarifying legislation is much needed. We fully concur with the Commerce Department's observation that "... the Act is not working as well as intended and that some modification of the Act is necessary if it is to serve its purpose more effectively."

Too many times in our fifty year history have we and our clients experienced the disruptive cycles of the traditional insurance marketplace, and we support maintaining the alternative risk sharing mechanisms permitted by the Act. We commend to your attention the ideas contained in the amendments proposed by the National Risk Retention Association (NRRA), for it is this kind of forward thinking that will enable us to help our clients more effectively.

Let us underscore that our support for clarification and strengthening of the Liability Risk Retention Act of 1986 does not indicate any desire to alter its essential scope or framework. We support the NRRA-proposed improvements to the Act which address the legitimate concerns raised by state regulators, however, we do not believe that the Act can achieve its intended potential in the current climate of adverse judicial and regulatory attack in certain areas.

We appreciate the opportunity for enlightened discussion that your hearings present, and look forward to receiving the results of the hearings. If Schinnerer & Company can be of help to the Committee in any way, please do not hesitate to call on us.

Yours sincerely,

Douglas C. Dolan, Jr.
Senior Vice President